

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-K

ANNUAL REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **December 31, 2017**

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 2-88927

### **FIRST KEYSTONE CORPORATION**

(Exact name of registrant as specified in its Charter)

**Pennsylvania**

(State or other jurisdiction of incorporation)

**23-2249083**

(I.R.S. Employer Identification Number)

**111 West Front Street Berwick, Pennsylvania**

(Address of principal executive offices)

**18603**

(Zip Code)

Registrant's telephone number, including area code: **(570) 752-3671**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, par value \$2.00 per share**

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes  No

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

Indicate by check mark whether the registrant has submitted electronically 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  No

Indicate by check mark if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-K contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions of "large accelerated filer," "accelerated filer," "small reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer  Non-accelerated filer   
Smaller reporting company  Emerging growth company

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

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

The aggregate market value of the registrant's outstanding voting common stock held by non-affiliates on June 30, 2017 determined by using a per share closing price on that date of \$27.00 as quoted on the Over the Counter Market, was \$136,336,662.

At March 2, 2018, there were 5,719,339 shares of Common Stock, \$2.00 par value, outstanding.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's 2018 definitive Proxy Statement are incorporated by reference in Part III of this Report.

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PART I

Forward Looking Statements

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements, which are included pursuant to the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to (a) projections or statements regarding future earnings, expenses, net interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure, and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, and (c) statements of assumptions, such as economic conditions in First Keystone Corporation’s (the “Corporation”) market areas. Such forward-looking statements can be identified by the use of forward-looking terminology such as “believes”, “expects”, “may”, “intends”, “will”, “should”, “anticipates”, or the negative of any of the foregoing or other variations thereon or comparable terminology, or by discussion of strategy.

Forward-looking statements are subject to certain risks and uncertainties such as local economic conditions, competitive factors, and regulatory limitations. Actual results may differ materially from those projected in the forward-looking statements. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: ineffectiveness of the business strategy due to changes in current or future market conditions; the effects of economic conditions on current and future customers, specifically the effect of the economy on loan customers’ ability to repay loans; possible impacts of the capital and liquidity requirements of Basel III standards and other regulatory pronouncements, regulations and rules; effects of short- and long-term federal budget and tax negotiations and their effects on economic and business conditions; changes in accounting principles, policies or guidelines as may be adopted by the regulatory agencies as well as the Public Company Accounting Oversight Board and the Financial Accounting Standards Board, and other accounting standards setters; the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet; governmental monetary and fiscal policies, as well as legislative and regulatory changes; the effects of new laws and regulations, specifically the impact of the Tax Cuts and Jobs Act, the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks; information technology difficulties, including technological changes; challenges in establishing and maintaining operations in new markets; volatilities in the securities markets; acquisitions and integration of acquired businesses; the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities; acts of war or terrorism; disruption of credit and equity markets; our ability to manage current levels of impaired assets; deposit flows; the loss of certain key officers; our ability to maintain the value and image of our brand and protect our intellectual property rights; continued relationships with major customers; the potential impact to the Corporation from continually evolving cybersecurity and other technological risks and attacks, including additional costs, reputational damage, regulatory penalties and financial losses; and the effect of general economic conditions and more specifically in the Corporation’s market area.

We caution readers not to place undue reliance on these forward-looking statements. They only reflect management’s analysis as of this date. The Corporation does not revise or update these forward-looking statements to reflect events or changed circumstances. Please carefully review the risk factors described in this document and in other documents the Corporation files from time to time with the Securities and Exchange Commission, including the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, and any Current Reports on Form 8-K.

## ITEM 1. BUSINESS

### General

First Keystone Corporation (the “Corporation”) is a Pennsylvania business corporation, and a bank holding company, registered with and supervised by the Board of Governors of the Federal Reserve System. The Corporation was incorporated on July 6, 1983, and commenced operations on July 2, 1984, upon consummation of the acquisition of all of the outstanding stock of First National Bank of Berwick (the predecessor to First Keystone Community Bank). The Corporation has one wholly-owned subsidiary, First Keystone Community Bank (the “Bank”), which has a commercial banking operation and trust department as its major lines of business. Since commencing operations, the Corporation’s business has consisted primarily of managing and supervising the Bank, and its principal source of income has been dividends paid by the Bank. Greater than 98% of the Corporation’s revenue and profit came from the commercial bank subsidiary for the years ended December 31, 2017, 2016, and 2015, and was the only reportable segment. At December 31, 2017, the Corporation had total consolidated assets, deposits and stockholders’ equity of approximately \$990 million, \$778 million and \$117 million, respectively.

The Bank was originally organized in 1864 as a national banking association. On October 1, 2010, the Bank converted from a national banking association to a Pennsylvania chartered commercial bank under the supervision of the Pennsylvania Department of Banking and Securities and the FDIC.

The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”) to the maximum extent of the law regulated by the FDIC and the Pennsylvania Department of Banking and Securities. The Bank is subject to regulation by the Federal Reserve Board governing reserves required to be maintained against certain deposits and other matters. The Bank is also a member of the Federal Home Loan Bank of Pittsburgh, which is one of the twelve regional cooperative banks comprising the system of Federal Home Loan Banks that lending institutions use to finance housing and economic development in local communities.

The Bank’s legal headquarters are located at 111 West Front Street, Berwick, Pennsylvania, from which it oversees the operations of its eighteen branch locations. These locations consist of five branches within Columbia County, eight branches within Luzerne County, one branch in Montour County, and four branches within Monroe County, Pennsylvania. For further information, please refer to Item 2 – Properties, and Note 13 — Commitments and Contingencies in the notes to the consolidated financial statements.

The Bank is a full service commercial bank providing a wide range of services to individuals and small to medium sized businesses in its Northeastern Pennsylvania market area. The Bank’s commercial banking activities include accepting time, demand and savings deposits and making secured and unsecured commercial, real estate and consumer loans. Additionally, the Bank provides personal and corporate trust and agency services to individuals, corporations and others, including trust investment accounts, investment advisory services, mutual funds, estate planning, and management of pension and profit sharing plans. The Bank’s business is not seasonal in nature. The Bank has no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Substantially all of the loans in the Bank’s portfolio have been originated by the Bank. Policies adopted by the Board of Directors are the basis by which the Bank conducts its lending activities.

At December 31, 2017, the Bank had 183 full-time employees and 21 part-time employees. In the opinion of management, the Bank enjoys a satisfactory relationship with its employees. The Bank is not a party to any collective bargaining agreement.

The Corporation’s internet website is [www.firstkeystonecorporation.com](http://www.firstkeystonecorporation.com) and the Bank’s internet website is [www.fkc.bank](http://www.fkc.bank).

When we say “we”, “us”, “our” or the “Corporation”, we mean the Corporation on a consolidated basis with the Bank.

### Primary Market Areas

The Bank’s primary market area reaches from Monroe and Montour counties along the Interstate 80 corridor through parts of Columbia and Luzerne counties as well as other adjoining counties. The Bank’s eastern market area is centered in Stroudsburg, Pennsylvania and serves all of Monroe county, as well as adjoining counties of Pike and Northampton. The area served by the Bank is a mix of rural communities and small to mid-sized towns. The current population of the Bank’s primary four-county footprint has decreased 1.6% since 2014 to 564,000 and is estimated to decrease 0.8% to 560,000 by 2023. As of June 30, 2017, the FDIC deposit market share data ranked the Bank 6th in the deposit market share out of the top 20 financial institutions in the four-county market, with 6.2% of deposits.

The Bank's headquarters, main office, and three of its branch offices are located in Berwick, Pennsylvania. Therefore, the Bank has a very strong presence in the Borough of Berwick, a community with a current population of approximately 12,000. The Bank ranks a commanding first in deposit market share in the Berwick market with 70.4% of deposits as of June 30, 2017, based on data compiled annually by the FDIC.

In the course of attracting and retaining deposits and originating loans, the Bank faces considerable competition. The Bank competes with 25 commercial banks, 2 savings associations, 1 thrift, and 47 credit unions for traditional banking products, such as deposits and loans in its primary four-county market area. Additionally, the Bank competes with consumer finance companies for loans, mutual funds and other investment alternatives for deposits. The Bank competes for deposits based on the ability to provide a range of competitively priced products, quality service, competitive rates, and convenient locations and hours. The competition among its peers for loan origination generally relates to interest rates offered, products available, ease of process, quality of service, and loan origination fees charged. The economic base of the Bank's market region is developed around small business, health care, educational facilities (college and public schools), light manufacturing industries, and agriculture.

The Bank continues to assess the market area to determine the best way to meet the financial needs of the communities it serves. Management continues to pursue new market opportunities based on a strategic plan to efficiently grow the Bank, improve earnings performance, and bring the Bank's products and services to new customers. Management strategically addresses growth opportunities versus competitive issues by determining the new products and services to be offered, evaluating expansion opportunities of its existing footprint with new locations, as well as investing in the expertise of skilled staffing. The Bank continues to succeed in serving its customers by living up to its motto, "Yesterday's Traditions. Tomorrow's Vision."

#### Competition - Bank

The Bank's competition is comprised of national, regional, community banking financial institutions and credit unions. The Bank's major competitors in Columbia, Luzerne, Montour and Monroe counties are:

- First Columbia Bank & Trust Co.
- PNC Bank, N.A.
- M & T Bank
- FNB Bank, N.A.
- Citizens Bank of Philadelphia
- Fidelity Deposit and Discount Bank
- Landmark Community Bank
- ESSA Bank & Trust
- First National Community Bank
- Service 1<sup>st</sup> FCU
- Jersey Shore State Bank
- Community Bank, N.A.
- Honesdale National Bank
- Peoples Security Bank
- Luzerne Bank
- First Northern Bank and Trust Co.

The Bank is generally competitive with all competing financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

#### Concentration

The Corporation and the Bank are not dependent on deposits nor exposed by loan concentrations to a single customer or to a small group of customers, such that the loss of any one or more would not have a materially adverse effect on the financial condition of the Corporation or the Bank. The Corporation has been successful in attracting municipal deposits, which make up 26.9% of total deposits at December 31, 2017. The largest municipal deposit customer consisted of a school district with deposit balances amounting to 15.8% of total deposits. The Corporation currently has the ability to utilize liquidity tools, such as wholesale borrowings, to replace reductions in municipal deposits. The customers' ability to repay their loans is generally dependent on the real estate market and general economic conditions prevailing in Pennsylvania, among other factors.

## Supervision and Regulation

The Corporation is subject to the jurisdiction of the Securities and Exchange Commission (the “SEC”) and of state securities laws for matters relating to the offering and sale of its securities. The Corporation is currently subject to the SEC’s rules and regulations relating to companies whose shares are registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”), as amended.

The Corporation is also subject to the provisions of the Bank Holding Company Act of 1956, as amended, and to supervision by the Federal Reserve Board. The Bank Holding Company Act requires the Corporation to secure the prior approval of the Federal Reserve Board before it owns or controls, directly or indirectly, more than 5% of the voting shares of substantially all of the assets of any institution, including another bank.

The Bank Holding Company Act also prohibits acquisition of control of a bank holding company, such as the Corporation, without prior notice to the Federal Reserve Board. Control is defined for this purpose as the power, directly or indirectly, to direct the management or policies of a bank holding company or to vote 25% (or 10%, if no other person or persons acting on concert, holds a greater percentage of the common stock) or more of the Corporation’s common stock.

The Corporation is required to file an annual report with the Federal Reserve Board and any additional information that the Federal Reserve Board may require pursuant to the Bank Holding Company Act. The Federal Reserve Board may also make examinations of the Corporation and any or all of its subsidiaries.

The Bank is subject to federal and state statutes applicable to banks chartered under the banking laws of Pennsylvania and to banks whose deposits are insured by the FDIC. The Bank is subject to supervision, regulation and examination by the Pennsylvania Department of Banking and Securities, the FDIC and the Consumer Financial Protection Bureau.

Federal and state banking laws and regulations govern, among other things, the scope of a bank’s business, the investments a bank may make, the reserves against deposits a bank must maintain, loans a bank makes and collateral it takes, and the activities of a bank with respect to mergers and consolidations and the establishment of branches.

As a subsidiary of a bank holding company, the Bank is subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or its subsidiaries, on investments in the stock or other securities of the bank holding company or its subsidiaries and on taking such stock or securities as collateral for loans. The Federal Reserve Act and Federal Reserve Board regulations also place certain limitations and reporting requirements on extensions of credit by a bank to principal shareholders of its parent holding company, among others, and to related interests of such principal shareholders. In addition, such legislation and regulations may affect the terms upon which any person becoming a principal shareholder of a holding company may obtain credit from banks with which the subsidiary bank maintains a correspondent relationship.

## Permitted Non-Banking Activities

The Federal Reserve Board permits bank holding companies to engage in non-banking activities so closely related to banking, managing or controlling banks as to be a proper incident thereto. The Corporation does not at this time engage in any of these non-banking activities, nor does the Corporation have any current plans to engage in any other permissible activities in the foreseeable future.

## Legislation and Regulatory Changes

From time to time, various types of federal and state legislation have been proposed that could result in additional regulations of, and restrictions on, the business of the Bank. It cannot be predicted whether any such legislation will be adopted or how such legislation would affect the business of the Bank. As a consequence of the extensive regulation of commercial banking activities in the United States, the Bank’s business is particularly susceptible to being affected by federal legislation and regulations that may increase the costs of doing business.

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. No prediction can be made as to the likelihood of any major changes or the impact such changes might have on the Corporation and the Bank. Certain changes of potential significance to the Corporation which have been enacted recently and others which are currently under consideration by Congress or various regulatory agencies are discussed below.

## Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”)

The FDICIA established five different levels of capitalization of financial institutions, with “prompt corrective actions” and significant operational restrictions imposed on institutions that are capital deficient under the categories. The five categories are:

- well capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized, and
- critically undercapitalized.

To be considered well capitalized, an institution must have a total risk-based capital ratio of at least 10%, a tier 1 risk-based capital ratio of at least 8%, a common equity tier 1 risk-based capital ratio of at least 6.5%, a leverage capital ratio of at least 5%, and must not be subject to any order or directive requiring the institution to improve its capital level. An institution falls within the adequately capitalized category if it has a total risk-based capital ratio of at least 8%, a tier 1 risk-based capital ratio of at least 6%, a common equity tier 1 risk-based capital ratio of at least 4.5%, and a leverage capital ratio of at least 4%. Institutions with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual capital levels. In addition, the appropriate federal regulatory agency may downgrade an institution to the next lower capital category upon a determination that the institution is in an unsafe or unsound condition, or is engaged in an unsafe or unsound practice. Institutions are required under the FDICIA to closely monitor their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category. On December 31, 2017, the Corporation and the Bank exceeded the minimum capital levels of the well capitalized category. See Note 15 — Regulatory Matters.

Regulatory oversight of an institution becomes more stringent with each lower capital category, with certain “prompt corrective actions” imposed depending on the level of capital deficiency.

### Other Provisions of the FDICIA

Each depository institution must submit audited financial statements to its primary regulator and the FDIC, whose reports are made publicly available. In addition, the audit committee of each depository institution must consist of outside directors and the audit committee at “large institutions” (as defined by FDIC regulation) must include members with banking or financial management expertise. The audit committee at “large institutions” must also have access to independent outside counsel. In addition, an institution must notify the FDIC and the institution’s primary regulator of any change in the institution’s independent auditor, and annual management letters must be provided to the FDIC and the depository institution’s primary regulator. The regulations define a “large institution” as one with over \$500 million in assets, which does include the Bank. Also, under the rule, an institution’s independent public accountant must examine the institution’s internal controls over financial reporting and perform agreed-upon procedures to test compliance with laws and regulations concerning safety and soundness.

Under the FDICIA, each federal banking agency must prescribe certain safety and soundness standards for depository institutions and their holding companies. Three types of standards must be prescribed:

- asset quality and earnings
- operational and managerial, and
- compensation .

Such standards would include a ratio of classified assets to capital, minimum earnings, and, to the extent feasible, a minimum ratio of market value to book value for publicly traded securities of such institutions and holding companies. Operational and managerial standards must relate to:

- internal controls, information systems and internal audit systems
- loan documentation
- credit underwriting
- interest rate exposure
- asset growth, and
- compensation, fees and benefits.

The FDICIA also sets forth Truth in Savings disclosure and advertising requirements applicable to all depository institutions.

*Real Estate Lending Standards.* Pursuant to the FDICIA, federal banking agencies adopted real estate lending guidelines which would set loan-to-value (“LTV”) ratios for different types of real estate loans. The LTV ratio is generally defined as the total loan amount divided by the appraised value of the property at the time the loan is originated. If the institution does not hold a first lien position, the total loan amount would be combined with the amount of all junior liens when calculating the ratio. In addition to establishing the LTV ratios, the guidelines require all real estate loans to be based upon proper loan documentation and a recent appraisal or certificate of inspection of the property.

### Regulatory Capital Requirements

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessment of the capital adequacy of a banking organization’s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off-balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 1,250% for assets with high credit risk, such as certain securitization exposures.

The following table presents the Bank’s capital ratios at December 31, 2017.

	(Dollars In Thousands)
Tier I Capital	\$ 85,963
Common Equity Tier 1 Capital	\$ 85,963
Tier II Capital	\$ 7,603
Total Capital	\$ 93,566
Adjusted Total Average Assets	\$972,524
Total Adjusted Risk-Weighted Assets <sup>1</sup>	\$658,454
Tier I Risk-Based Capital Ratio <sup>2</sup>	13.06%
Required Tier I Risk-Based Capital Ratio (plus Capital Buffer)	7.25%
Excess Tier I Risk-Based Capital Ratio	5.81%
Common Equity Tier 1 Risk-Based Capital Ratio <sup>3</sup>	13.06%
Required Common Equity Tier 1 Risk-Based Capital Ratio (plus Capital Buffer)	5.75%
Excess Common Equity Tier 1 Risk-Based Capital Ratio	7.31%
Total Risk-Based Capital Ratio <sup>4</sup>	14.21%
Required Total Risk-Based Capital Ratio (plus Capital Buffer)	9.25%
Excess Total Risk-Based Capital Ratio	4.96%
Tier I Leverage Ratio <sup>5</sup>	8.84%
Required Tier I Leverage Ratio	4.00%
Excess Tier I Leverage Ratio	4.84%

<sup>1</sup>Includes off-balance sheet items at credit-equivalent values less intangible assets.

<sup>2</sup>Tier I Risk-Based Capital Ratio is defined as the ratio of Tier I Capital to Total Adjusted Risk-Weighted Assets.

<sup>3</sup>Common Equity Tier 1 Risk-Based Capital Ratio is defined as the ratio of Common Equity Tier 1 Capital to Total Adjusted Risk-Weighted Assets.

<sup>4</sup>Total Risk-Based Capital Ratio is defined as the ratio of Tier I and Tier II Capital to Total Adjusted Risk-Weighted Assets.

<sup>5</sup>Tier I Leverage Ratio is defined as the ratio of Tier I Capital to Adjusted Total Average Assets.

The Corporation’s capital ratios are not materially different than those of the Bank.

The Corporation’s ability to maintain the required levels of capital is substantially dependent upon the success of the Corporation’s capital and business plans; the impact of future economic events on the Corporation’s loan customers; and the Corporation’s ability to manage its interest rate risk and investment portfolio and control its growth and other operating expenses. See also the information under Capital Strength in Management’s Discussion and Analysis on page 42 of this report.



## Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations began January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) were required to comply by January 1, 2014. The final rules call for the following capital requirements:

- A minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%.
- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
- A minimum ratio of total capital to risk-weighted assets of 8%.
- A minimum leverage ratio of 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations began on January 1, 2016. The capital level required to avoid restrictions on elective distributions applicable to the Bank were as follows:

- A common equity tier 1 capital ratio of 5.750%.
- A tier 1 risk-based capital ratio of 7.250%.
- A total risk-based capital ratio of 9.250%.

As of December 31, 2017, the Bank maintained capital ratios above the required capital conservation buffer.

Under the initially proposed rules, accumulated other comprehensive income (“AOCI”) would have been included in a banking organization’s common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The Bank elected to opt-out of this item with the filing of the March 31, 2015 Call Report.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010. The Corporation does not have trust preferred securities or cumulative perpetual preferred stock with no plans to add these to the capital structure.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets and certain deferred tax assets are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

The Corporation has assessed the impact of these changes on the regulatory ratios of the Corporation and the Bank on the capital, operations, liquidity and earnings of the Corporation and Bank, and concluded that the new rules did not have a material negative effect.

## Effect of Government Monetary Policies

The earnings of the Corporation are and will be affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies.

The Federal Reserve Board has had, and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order to, among other things, curb inflation or combat a recession. The Federal Reserve Board has a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States government securities and through its regulations of, among other things, the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

## Effects of Inflation

Inflation has some impact on the Bank's operating costs. Unlike industrial companies, however, substantially all of the Bank's assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on the Bank's performance than the general levels of inflation. Over short periods of time, interest rates may not necessarily move in the same direction or in the same magnitude as prices of goods and services.

## Environmental Regulation

There are several federal and state statutes that regulate the obligations and liabilities of financial institutions pertaining to environmental issues. In addition to the potential for attachment of liability resulting from its own actions, a bank may be held liable, under certain circumstances, for the actions of its borrowers, or third parties, when such actions result in environmental problems on properties that collateralize loans held by the bank. Further, the liability has the potential to far exceed the original amount of the loan issued by the Bank. Currently, neither the Corporation nor the Bank is a party to any pending legal proceeding pursuant to any environmental statute, nor are the Corporation and the Bank aware of any circumstances that may give rise to liability under any such statute.

## Interest Rate Risk

Federal banking agency regulations specify that the Bank's capital adequacy include an assessment of the Bank's interest rate risk exposure. The standards for measuring the adequacy and effectiveness of a banking organization's Interest Rate Risk ("IRR") management includes a measurement of Board of Directors and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. The Bank has internal IRR models that are used to measure and monitor IRR. Additionally, the regulatory agencies have been assessing IRR on an informal basis for several years. For these reasons, the Corporation does not expect the addition of IRR evaluation to the agencies' capital guidelines to result in significant changes in capital requirements for the Bank.

## Tax Cuts and Jobs Act

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law. Among other changes, the Tax Cuts and Jobs Act reduces the federal corporate tax rate from 35% to 21% effective January 1, 2018. The Corporation anticipates that this tax rate change should reduce its federal income tax liability in future years beginning with 2018. However, the Corporation did recognize certain effects of the tax law changes in 2017. U.S. generally accepted accounting principles require companies to revalue their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment. Since the enactment took place in December 2017, the Corporation revalued its net deferred tax assets in the fourth quarter of 2017 resulting in an approximate \$379,000 reduction to earnings in 2017.

## JOBS Act

In 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") became law. The JOBS Act is aimed at facilitating capital raising by smaller companies, banks and bank holding companies by implementing the following changes:

- Raising the threshold requiring registration under the Exchange Act for banks and bank holdings companies from 500 to 2,000 holders of record;

- Raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;
- Raising the limit for Regulation A offerings from \$5 million to \$50 million per year and exempting some Regulation A offerings from state blue sky laws;
- Permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;
- Allowing private companies to use "crowdfunding" to raise up to \$1 million in any 12-month period, subject to certain conditions; and
- Creating a new category of issuer, called an "Emerging Growth Company," for companies with less than \$1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity initial public offering and complying with public company reporting obligations for up to five years.

The JOBS Act has not had any application to the Corporation, and management will continue to monitor the implementation rules for potential effects that might benefit the Corporation.

#### The Gramm-Leach-Bliley Act of 1999

In 1999, the Gramm-Leach-Bliley Act became law, which is also known as the Financial Services Modernization Act. The act repealed some Depression-era banking laws and will permit banks, insurance companies and securities firms to engage in each others' businesses after complying with certain conditions and regulations. The act grants to community banks the power to enter new financial markets as a matter of right that larger institutions have managed to do on an ad hoc basis. At this time, the Corporation has no plans to pursue these additional possibilities.

#### The Sarbanes-Oxley Act

In 2002, the Sarbanes-Oxley Act became law. The Act was in response to public concerns regarding corporate accountability in connection with recent high visibility accounting scandals. The stated goals of the Sarbanes-Oxley Act are:

- To increase corporate responsibility;
- To provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies; and
- To protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The Sarbanes-Oxley Act generally applies to all companies, both U.S. and non-U.S., that file periodic reports with the SEC under the Exchange Act. The legislation includes provisions, among other things:

- Governing the services that can be provided by a public company's independent auditors and the procedures for approving such services;
- Requiring the chief executive officer and chief financial officer to certify certain matters relating to the company's periodic filings under the Exchange Act;
- Requiring expedited filings of reports by insiders of their securities transactions and containing other provisions relating to insider conflicts of interest;
- Increasing disclosure requirements relating to critical financial accounting policies and their application;
- Increasing penalties for securities law violations; and
- Creating a public accounting oversight board, a regulatory body subject to SEC jurisdiction with broad powers to set auditing, quality control and ethics standards for accounting firms.

#### Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") became law in July 2010. Dodd-Frank is intended to affect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created a new Financial Stability Oversight Council to identify systemic risks in the financial system and gave federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally created a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank continues to have a significant impact on our business operations as its provisions are amended and requirements are clarified. Community banks have seen an increase in operating and compliance costs and interest expense. Among the provisions that have affected us are the following:

***Holding Company Capital Requirements.*** Dodd-Frank requires the Federal Reserve to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than \$15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

***Deposit Insurance.*** Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Effective one year from the date of enactment, Dodd-Frank eliminates the federal statutory prohibition against the payment of interest on business checking accounts.

***Corporate Governance.*** Dodd-Frank requires publicly traded companies to give stockholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on “golden parachute” payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The SEC has finalized the rules implementing these requirements which took effect on January 21, 2011. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of \$1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

***Prohibition Against Charter Conversions of Troubled Institutions.*** Effective one year after enactment, Dodd-Frank prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

***Interstate Branching.*** Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

***Limits on Interstate Acquisitions and Mergers.*** Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition — the acquisition of a bank outside its home state — unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

***Limits on Interchange Fees.*** Dodd-Frank amends the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. On June 29, 2011, the Federal Reserve Board set the interchange rate cap at \$0.24 per transaction. While the restrictions on interchange fees do not affect banks with assets less than \$10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks.

***Consumer Financial Protection Bureau.*** Dodd-Frank creates a new, independent federal agency called the Consumer Financial Protection Bureau (“CFPB”), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The

CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

#### Department of Defense Military Lending Rule

In 2015, the U.S. Department of Defense issued a final rule which restricts pricing and terms of certain credit extended to active duty military personnel and their families. This rule, which was implemented effective October 3, 2016, caps the interest rate on certain credit extensions to an annual percentage rate of 36% and restricts other fees. The rule requires financial institutions to verify whether customers are military personnel subject to the rule. The impact of this final rule, and any subsequent amendments thereto, on the Corporation's lending activities and the Corporation's statements of income or condition has had little or no impact; however, management will continue to monitor the implementation of the rule for any potential side effects on the Corporation's business.

#### Available Information

The Corporation's common stock is registered under Section 12(g) of the Exchange Act. The Corporation is subject to the informational requirements of the Exchange Act, and, accordingly, files reports, proxy statements and other information with the SEC. The reports, proxy statements and other information filed with the SEC are available for inspection and copying at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The Corporation is an electronic filer with the SEC. The SEC maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC's internet site address is [www.sec.gov](http://www.sec.gov).

A copy of the Corporation's Annual Report on Form 10-K may be obtained without charge at [www.fkyscorp.com](http://www.fkyscorp.com) or via email at [info@fkcbank.com](mailto:info@fkcbank.com). Quarterly reports on Form 10-Q, current event reports on Form 8-K, and amendments to these reports, may be obtained without charge via email at [info@fkcbank.com](mailto:info@fkcbank.com). Information may also be obtained via written request to Investor Relations at First Keystone Corporation, Attention: Cheryl Wynings, 111 West Front Street, P.O. Box 289, Berwick, Pennsylvania 18603, or by telephone at 570-752-3671, extension 1175.

#### ITEM 1A. RISK FACTORS

Investments in the Corporation's common stock involve risk. The market price of the Corporation's common stock may fluctuate significantly in response to a number of factors, including:

*The Corporation is subject to interest rate risk.*

The Corporation's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Corporation's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Corporation receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Corporation's ability to originate loans and obtain deposits, (ii) the fair value of the Corporation's financial assets and liabilities, and (iii) the average duration of the Corporation's mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Corporation's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the Corporation's results of operations, any substantial, unexpected, or prolonged change in market interest rates could have a material adverse effect on the Corporation's financial condition and results of operations.

*The Corporation is subject to lending risk.*

As of December 31, 2017, approximately 69.8% of the Corporation's loan portfolio consisted of Commercial and Industrial loans and Commercial Real Estate loans (including construction loans) of which both include a tax-free component. These types of loans are generally viewed as having more risk of default than Residential Real Estate loans or Consumer loans. Commercial and Industrial and Commercial Real Estate loans are also typically larger than Residential Real Estate loans and Consumer loans. Because the Corporation's loan portfolio contains a significant number of Commercial and Industrial and Commercial Real Estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation's financial condition and results of operations.

*If the Corporation's Allowance for Loan Losses is not sufficient to cover actual loan losses, earnings could decrease.*

The Corporation's loan customers may not repay their loans according to the terms of their loans, and the collateral securing the payment of their loans may be insufficient to assure repayment. The Corporation may experience significant credit losses, which could have a material adverse effect on its operating results. In determining the amount of the allowance for loan losses, the Corporation reviews its loans and loss and delinquency experience and evaluates economic conditions. If the Corporation's assumptions prove to be incorrect, the allowance for loan losses may not cover inherent losses in its loan portfolio at the date of the financial statements. Material additions to the Corporation's allowance would materially decrease net income. At December 31, 2017, the allowance for loan losses totaled \$7.5 million, representing 1.40% of average total loans.

Although the Corporation believes its underwriting standards are sufficient to manage normal lending risks, it is difficult to assess the future performance of the loan portfolio due to ongoing new originations. The Corporation cannot assure that non-performing loans will not increase or that non-performing or delinquent loans will not adversely affect future performance.

In addition, federal regulators periodically review the Corporation's allowance for loan losses and may require it to increase the allowance for loan losses or recognize further loan charge-offs. Any increase in the allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a material adverse effect on the results of operations and financial condition.

*The Corporation's operations of its business, including its interaction with customers, are increasingly done via electronic means, and this has increased risks related to cyber security.*

The Corporation is exposed to the risk of cyber-attacks in the normal course of business. In general, cyber incidents can result from deliberate attacks or unintentional events. The Corporation has observed an increased level of attention in the industry focused on cyber-attacks that include, but are not limited to, gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption. To combat against these attacks, the Corporation has policies and procedures in place to prevent or limit the effect of the possible security breach of its information systems and it has insurance against some cyber-risks and attacks. While the Corporation has not incurred any material losses related to cyber-attacks, nor is it aware of any specific or threatened cyber-incidents as of the date of this report, it may incur substantial costs and suffer other negative consequences if it falls victim to successful cyber-attacks. Such negative consequences could include remediation costs that may include liability for stolen assets or information and repairing system damage that may have been caused; deploying additional personnel and protection technologies, training employees, and engaging third party experts and consultants; lost revenues resulting from unauthorized use of proprietary information or the failure to retain or attract customers following an attack; disruption or failures of physical infrastructure, operating systems or networks that support our business and customers resulting in the loss of customers and business opportunities; additional regulatory scrutiny and possible regulatory penalties; litigation; and reputational damage adversely affecting customer or investor confidence.

*The Corporation's information systems may experience an interruption or breach in security.*

The Corporation relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Corporation's customer relationship management, general ledger, deposit, loan and other systems. The Corporation has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems; however, there can be no assurance that any such failures, interruptions or security breaches will not occur. While the Corporation maintains insurance coverage that may, subject to policy terms and conditions including significant self-insured deductibles, cover certain aspects of cyber risks, such insurance coverage may be insufficient to cover all losses. The occurrence of any failures, interruptions or security breaches of the Corporation's information systems could damage the Corporation's reputation adversely affecting customer or investor confidence, result in a loss of customer business, subject the Corporation to additional regulatory scrutiny and possible regulatory penalties, or expose the Corporation to civil litigation and possible financial liability, any of which could have a material adverse effect on the Corporation's financial condition and results of operations.

*Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact the Corporation's business.*

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Corporation's ability to conduct business. Such events could affect the stability of the Corporation's deposit base; impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Corporation to incur additional expenses. Severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Corporation's business, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

*The Corporation operates in a highly competitive industry.*

The Corporation faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources and greater technology. Such competitors primarily include national, regional and community banks within the various markets in which the Corporation operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as online account opening, automatic transfer and automatic payment systems. Many of the Corporation's competitors have fewer regulatory constraints and may have lower cost structures.

The Corporation's ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- The ability to expand the Corporation's market position;
- The scope, relevance and pricing of products and services offered to meet customer needs and demands;
- The rate at which the Corporation introduces new products and services relative to its competitors;
- Customer satisfaction with the Corporation's level of service; and
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Corporation's competitive position, which could adversely affect the Corporation's growth and profitability, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

*New lines of business or new products and services may subject the Corporation to additional risks.*

From time-to-time, the Corporation may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services, the Corporation may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new

product or service could have a significant impact on the effectiveness of the Corporation's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Corporation's business, results of operations and financial condition.

*The Basel III capital requirements may require the Corporation to maintain higher levels of capital, which could reduce its profitability.*

Basel III targets higher levels of base capital, certain capital buffers and a migration toward common equity as the key source of regulatory capital. Although the new capital requirements are phased in over the next decade and may change substantially before final implementation, Basel III signals a growing effort by domestic and international bank regulatory agencies to require financial institutions, including depository institutions, to maintain higher levels of capital. As Basel III is implemented, regulatory viewpoints could change or require additional capital to support the Corporation's business risk profile prior to final implementation of the Basel III standards. If the Corporation and the Bank are required to maintain higher levels of capital, the Corporation and the Bank may have fewer opportunities to invest capital into interest-earning assets, which could limit the profitable business operations available to the Corporation and the Bank and adversely impact its financial condition and results of operations.

*Federal income tax reform could have unforeseen effects on our financial condition and results of operations.*

On December 22, 2017, the President of the United States signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." The Corporation is still in the process of analyzing the Tax Cuts and Jobs Act and its possible effects on the Corporation. The Tax Cuts and Jobs Act includes a number of provisions, including the lowering of the U.S. corporate tax rate from 34 percent to 21 percent, effective January 1, 2018. There are also provisions that may partially offset the benefit of such rate reduction. Financial statement impacts include adjustments for, among other things, the re-measurement of deferred tax assets and liabilities. While there are benefits, there is also substantial uncertainty regarding the details of U.S. Tax Reform. The intended and unintended consequences of Tax Cuts and Jobs Act on our business and on holders of our common shares is uncertain and could be adverse. The Corporation anticipates that the impact of Tax Cuts and Jobs Act may be material to our business, financial condition and results of operations.

*If the Corporation concludes that the decline in value of any of its investment securities is other than temporary, the Corporation will be required to write down the credit-related portion of the impairment of that security through a charge to earnings.*

Management reviews its investment securities portfolio at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of its investment securities has declined below its carrying value, management is required to assess whether the decline is other than temporary. If management concludes that the decline is other than temporary, management will be required to write down the credit-related portion of the impairment of that security through a charge to earnings. Due to the complexity of the calculations and assumptions used in determining whether an asset is impaired, the impairment disclosed may not accurately reflect the actual impairment in the future.

*The changes in control of the United States government and issues relating to debt and the deficit may adversely affect the Corporation.*

Due to the Republican Party controlling of the White House, as well as the Republican Party maintaining or losing control of both the House of Representatives and Senate of the United States in future elections, could result in significant changes (or uncertainty) in governmental policies, regulatory environments, spending sentiment and many other factors and conditions, some of which could adversely impact the Corporation's business, financial condition and results of operations.

In addition, as a result of past difficulties of the federal government to reach agreement over federal debt and the ongoing issues connected with the debt ceiling, certain rating agencies placed the United States government's long-term sovereign debt rating on their equivalent of negative watch and announced the possibility of a rating downgrade. The rating agencies, due to constraints related to the rating of the United States, also placed government-sponsored enterprises in which the Corporation invests and receives lines of credit on negative watch and a downgrade of the United States' credit rating would trigger a similar downgrade in the credit rating of these government sponsored enterprises. Furthermore, the credit rating of other entities, such as state and local governments, may also be downgraded should the United States credit rating be downgraded. The impact that a credit rating downgrade may have on the national and local economy could have an adverse effect on the Corporation's financial condition and results of operations.



*The Corporation's profitability depends significantly on economic conditions in the Commonwealth of Pennsylvania.*

The Corporation's success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers primarily in Columbia, Luzerne, Montour and Monroe counties. The local economic conditions in these areas have a significant impact on the demand for the Corporation's products and services as well as the ability of the Corporation's customers to repay loans, the value of the collateral securing loans and the stability of the Corporation's deposit funding sources. Also, a significant decline in general economic conditions could impact the local economic conditions and, in turn, have a material adverse effect on the Corporation's financial condition and results of operations.

*The Corporation's future acquisitions could dilute stockholders' ownership and may cause the Corporation to become more susceptible to adverse economic events.*

The Corporation may use its common stock to acquire other companies or make investments in banks and other complementary businesses in the future. The Corporation may issue additional shares of common stock to pay for future acquisitions, which would dilute stockholders' ownership interest in the Corporation. Future business acquisitions could be material to the Corporation, and the degree of success achieved in acquiring and integrating these businesses into the Corporation could have a material effect on the value of the Corporation's common stock. In addition, any acquisition could require the Corporation to use substantial cash or other liquid assets or to incur debt. In those events, the Corporation could become more susceptible to economic downturns and competitive pressures.

*The Corporation may not be able to attract and retain skilled people.*

The Corporation's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Corporation can be intense and the Corporation may not be able to hire people or to retain them. The unexpected loss of services of one or more of the Corporation's key personnel could have a material adverse impact on the Corporation's business because of their skills, knowledge of the Corporation's market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

*The Corporation is subject to extensive government regulation and supervision.*

The Corporation, primarily through the Bank, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect the Corporation's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies could affect the Corporation in substantial and unpredictable ways. Such changes could subject the Corporation to additional costs, limit the types of financial services and products the Corporation may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Corporation's business, financial condition and results of operations.

*The Corporation is subject to claims and litigation pertaining to fiduciary responsibility.*

From time to time, customers make claims and take legal action pertaining to the Corporation's performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Corporation's performance of its fiduciary responsibilities are founded or unfounded, and if such claims and legal actions are not resolved in a manner favorable to the Corporation, they may result in significant financial liability and/or adversely affect the market perception of the Corporation and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation's financial condition and results of operations.

*The trading volume in the Corporation's common stock is less than that of other larger financial services companies.*

The Corporation's common stock is not currently listed on a national stock exchange, but traded on the Over the Counter Market. As a result, trading volume is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation's common stock, significant sales of the Corporation's common stock, or the expectation of these sales, could cause the Corporation's stock price to fall.

*The Corporation's controls and procedures may fail or be circumvented.*

Management regularly reviews and updates the Corporation's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Corporation's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Corporation's business, results of operations and financial condition.

We identified a material weakness in our internal control over financial reporting at December 31, 2016 and cannot assure you that additional material weaknesses will not be identified in the future. If we fail to implement and maintain effective internal control over financial reporting, it could result in material misstatements in our financial statements in the future, which could require us to restate financial statements, cause investors to lose confidence in our reported financial information, and have a negative effect on our stock price.

Our management identified a material weakness in our internal control over financial reporting at December 31, 2016. See Item 9A, "Controls and Procedures." While the material weakness had no impact upon our reported financial condition or results of operation at and for the fiscal year ended December 31, 2016, any prior periods or subsequent periods, we cannot assure you that additional significant deficiencies or material weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in additional material weaknesses, cause us to fail to meet our periodic reporting obligations or result in material misstatements in our financial statements in future periods. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules promulgated by the SEC under Section 404. The existence of a material weakness could result in errors in our financial statements in future periods that could result in a restatement of financial statements, cause us to fail to meet our reporting obligations, and cause investors or customers to lose confidence in our reported financial information, leading to a decline in our stock price or a loss of business.

*The Corporation continually encounters technological change.*

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Corporation's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Corporation's operations. Many of the Corporation's competitors have substantially greater resources to invest in technological improvements. The Corporation may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Corporation's business and, in turn, the Corporation's financial condition and results of operations.

*The Corporation may need or be compelled to raise additional capital in the future, but that capital may not be available when it is needed and on terms favorable to current shareholders.*

Federal banking regulators require the Corporation and Bank to maintain adequate levels of capital to support their operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by the Corporation's management and board of directors, based on capital levels that they believe are necessary to support the Corporation's business operations. The Corporation is evaluating its present and future capital requirements and needs, is developing a comprehensive capital plan and is analyzing capital raising alternatives, methods and options. Even if the Corporation succeeds in meeting the current regulatory capital requirements, the Corporation may need to raise additional capital in the near future to support possible loan losses during future periods or to meet future regulatory capital requirements.

Further, the Corporation's regulators may require it to increase its capital levels. If the Corporation raises capital through the issuance of additional shares of its common stock or other securities, it would likely dilute the ownership interests of current investors and would likely dilute the per-share book value and earnings per share of its common stock. Furthermore, it may have an adverse impact on the Corporation's stock price. New investors may also have rights, preferences and privileges senior to the Corporation's current shareholders, which may adversely impact its current shareholders. The Corporation's ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside its control, and on its financial performance. Accordingly, the Corporation cannot assure the shareholders of its ability to raise additional capital on terms and time frames acceptable to it or to raise additional capital at all. If the Corporation cannot raise additional capital in sufficient amounts when needed, its ability to comply with regulatory capital requirements could be materially impaired. Additionally, the inability to raise capital in sufficient amounts may adversely affect the Corporation's operations, financial condition and results of operations.

*The Corporation is subject to environmental liability risk associated with lending activities.*

A significant portion of the Corporation's loan portfolio is secured by real property. During the ordinary course of business, the Corporation may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Corporation may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Corporation to incur substantial expenses and may materially reduce the affected property's value or limit the Corporation's ability to use or sell the affected property. In addition, future laws, or more stringent interpretations or enforcement policies with respect to existing laws, may increase the Corporation's exposure to environmental liability. Although the Corporation has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Corporation's financial condition and results of operations.

*The Corporation's ability to pay dividends is subject to limitations.*

The Corporation is a bank holding company and its operations are conducted by the Bank, which is a separate and distinct legal entity. Substantially all of the Corporation's assets are held by the Bank.

The Corporation's ability to pay dividends depends on its receipt of dividends from the Bank, its primary source of dividends. Dividend payments from the Bank are subject to legal and regulatory limitations, generally based on net profits and retained earnings, imposed by the various banking regulatory agencies. The ability of banking subsidiaries to pay dividends is also subject to their profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that the Bank will be able to pay dividends in the future or that the Corporation will generate adequate cash flow to pay dividends in the future. The Corporation's failure to pay dividends on its common stock could have a material adverse effect on the market price of its common stock.

*Pennsylvania Business Corporation Law and various anti-takeover provisions under its Articles of Incorporation and Bylaws could impede the takeover of the Corporation.*

Various Pennsylvania laws affecting business corporations may have the effect of discouraging offers to acquire the Corporation, even if the acquisition would be advantageous to shareholders. In addition, the Corporation has various anti-takeover measures in place under its Articles of Incorporation and Bylaws, including a staggered board of directors and the absence of cumulative voting. Any one or more of these measures may impede the takeover of the Corporation without the approval of its Board of Directors and may prevent its shareholders from taking part in a transaction in which they could realize a premium over the current market price of its common stock.

*The Corporation's banking subsidiary may be required to pay higher FDIC insurance premiums or special assessments which may adversely affect its earnings.*

Since the Great Recession, poor economic conditions and the resulting bank failures increased the costs of the FDIC and depleted its deposit insurance fund. In more recent history, the FDIC fund position has improved and the cost basis has been updated which in some cases can result in decreased costs of the insurance fund. Additional bank failures may prompt the FDIC to increase its premiums above the recently increased levels or to issue special assessments. The Corporation is generally unable to control the amount of premiums or special assessments that its subsidiary is required to pay for FDIC insurance. Any future changes in the calculation or assessment of FDIC insurance premiums may have a material adverse effect on the Corporation's results of operations, financial condition, and its ability to continue to pay dividends on its common stock at the current rate or at all.

*The increasing use of social media platforms presents new risks and challenges and our inability or failure to recognize, respond to and effectively manage the accelerated impact of social media could materially adversely impact our business.*

There has been a marked increase in the use of social media platforms, including weblogs (blogs), social media websites, and other forms of Internet-based communications which allow individuals access to a broad audience of consumers and other interested persons. Social media practices in the banking industry are evolving, which creates uncertainty and risk of noncompliance with regulations applicable to our business. Consumers value readily available information concerning businesses and their goods and services and often act on such information without further investigation and without regard to its accuracy. Many social media platforms immediately publish the content their subscribers and participants post, often without filters or checks on accuracy of the content posted. Information posted on such platforms at any time may be adverse to our interests and/or may be inaccurate. The dissemination of information online could harm our business, prospects, financial condition, and results of operations, regardless of the information's accuracy. The harm may be immediate without affording us an opportunity for redress or correction.

Other risks associated with the use of social media include improper disclosure of proprietary information, negative comments about our business, exposure of personally identifiable information, fraud, out-of-date information, and improper use by employees and customers. The inappropriate use of social media by our customers or employees could result in negative consequences including remediation costs including training for employees, additional regulatory scrutiny and possible regulatory penalties, litigation or negative publicity that could damage our reputation adversely affecting customer or investor confidence.

#### ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

The Corporation and its subsidiary occupy eighteen branch properties in Columbia, Luzerne, Montour and Monroe counties in Pennsylvania, which are used principally as banking offices.

Properties owned are:

- Main Office located at 111 West Front Street, Berwick, Pennsylvania 18603;
- Salem Office located at 400 Fowler Avenue, Berwick, Pennsylvania 18603;
- Freas Avenue Office located at 701 Freas Avenue, Berwick, Pennsylvania 18603;
- Scott Township Office located at 2301 Columbia Boulevard, Bloomsburg, Pennsylvania 17815;
- Mifflinville Office located at West Third and Race Streets, Mifflinville, Pennsylvania 18631;
- Hanover Township Office located at 1540 Sans Souci Parkway, Hanover Township, Pennsylvania 18706;
- Danville Office located at 1049 Bloom Road, Danville, Pennsylvania 17821;
- Mountainhome Office located at 1154 Route 390, Cresco, Pennsylvania 18326;
- Brodheadsville Office located at 2022 Route 209, Brodheadsville, Pennsylvania 18322;
- Swiftwater Office located at 2070 Route 611, Swiftwater, Pennsylvania 18370;
- Plymouth Office located at 463 West Main Street, Plymouth, Pennsylvania 18651;
- Kingston Office located at 299 Wyoming Avenue, Kingston, Pennsylvania 18704;
- Dallas Office located at 2325 Memorial Highway, Dallas, Pennsylvania 18612;
- Shickshinny Office located at 107 South Main Street, Shickshinny, Pennsylvania 18655;
- Stroudsburg Office located at 559 Main Street, Stroudsburg, Pennsylvania 18360;
- Properties located at Second and Market Streets, and Third and Bowman Streets, Berwick, Pennsylvania 18603; and
- 20 ATMs located in Columbia, Luzerne, Montour and Monroe counties.

Properties leased are:

- Briar Creek Office located inside the Giant Market at 50 Briar Creek Plaza, Berwick, Pennsylvania 18603;
- Nescopeck Office located at 437 West Third Street, Nescopeck, Pennsylvania 18635; and
- Mountain Top Office located at 18 North Mountain Boulevard, Mountain Top, Pennsylvania 18707 (land parcel is leased and the bank building is owned).

## ITEM 3. LEGAL PROCEEDINGS

The Corporation and/or the Bank are defendants in various legal proceedings arising in the ordinary course of their business. However, in the opinion of management of the Corporation and the Bank, there are no proceedings pending to which the Corporation and the Bank is a party or to which their property is subject, which, if determined adversely to the Corporation and the Bank, would be material in relation to the Corporation's and Bank's individual profits or financial condition, nor are there any proceedings pending other than ordinary routine litigation incident to the business of the Corporation and the Bank. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Corporation and the Bank by government authorities or others.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Corporation’s common stock is traded in the over-the-counter market on the OTC Market under the symbol “FKYS”. The following table sets forth:

- The quarterly high and low prices for a share of the Corporation’s common stock during the periods indicated as reported to the management of the Corporation;
- Quarterly dividends on a share of the common stock paid with respect to each quarter since January 1, 2016; and
- The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

MARKET VALUE OF COMMON STOCK

	<u>High</u>	<u>Low</u>	<u>Per Share Dividend Paid</u>
<b>2017</b>			
First quarter	<b>\$26.50</b>	<b>\$24.25</b>	<b>\$0.27</b>
Second quarter	<b>\$27.65</b>	<b>\$25.01</b>	<b>\$0.27</b>
Third quarter	<b>\$28.25</b>	<b>\$26.50</b>	<b>\$0.27</b>
Fourth quarter	<b>\$29.30</b>	<b>\$27.00</b>	<b>\$0.27</b>
<b>2016</b>			
First quarter	\$26.50	\$24.00	\$0.27
Second quarter	\$27.80	\$24.98	\$0.27
Third quarter	\$27.25	\$24.00	\$0.27
Fourth quarter	\$26.50	\$23.92	\$0.27

As of December 31, 2017, the Corporation had approximately 934 shareholders of record.

The Corporation has paid dividends since commencement of business in 1984. It is the present intention of the Corporation’s Board of Directors to continue the dividend payment policy. Stock value, cost and availability of external capital, and the Corporation’s present and anticipated capital needs are weighed in the process of making a responsible decision. Further dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors relevant at the time the Board of Directors of the Corporation considers its dividend policy. Cash available for dividend distributions to shareholders of the Corporation must initially come from dividends paid by the Bank to the Corporation. Therefore, the restrictions on the Bank’s dividend payments are directly applicable to the Corporation.

Transfer Agent:

Computershare (800) 368-5948  
P.O. Box 30170  
College Station, TX 77842-3170

The following brokerage firms make a market in First Keystone Corporation common stock:

RBC Wealth Management	(800) 223-4207
Janney Montgomery Scott LLC	(800) 526-6397
Stifel Nicolaus & Co. Inc.	(800) 679-5446
Boenning & Scattergood, Inc.	(800) 883-1212

#### Dividend Restrictions on the Bank

Generally, as a Pennsylvania state chartered bank, under Pennsylvania banking law, the Bank may only pay dividends out of accumulated net earnings.

#### Dividend Restrictions on the Corporation

Under the Pennsylvania Business Corporation Law of 1988, as amended, the Corporation may not pay a dividend if, after giving effect thereto, either:

- The Corporation would be unable to pay its debts as they become due in the usual course of business; or
- The Corporation's total assets would be less than its total liabilities.

The determination of total assets and liabilities may be based upon:

- Financial statements prepared on the basis of generally accepted accounting principles;
- Financial statements that are prepared on the basis of other accounting practices and principles that are reasonable under the circumstances; or
- A fair valuation or other method that is reasonable under the circumstances.

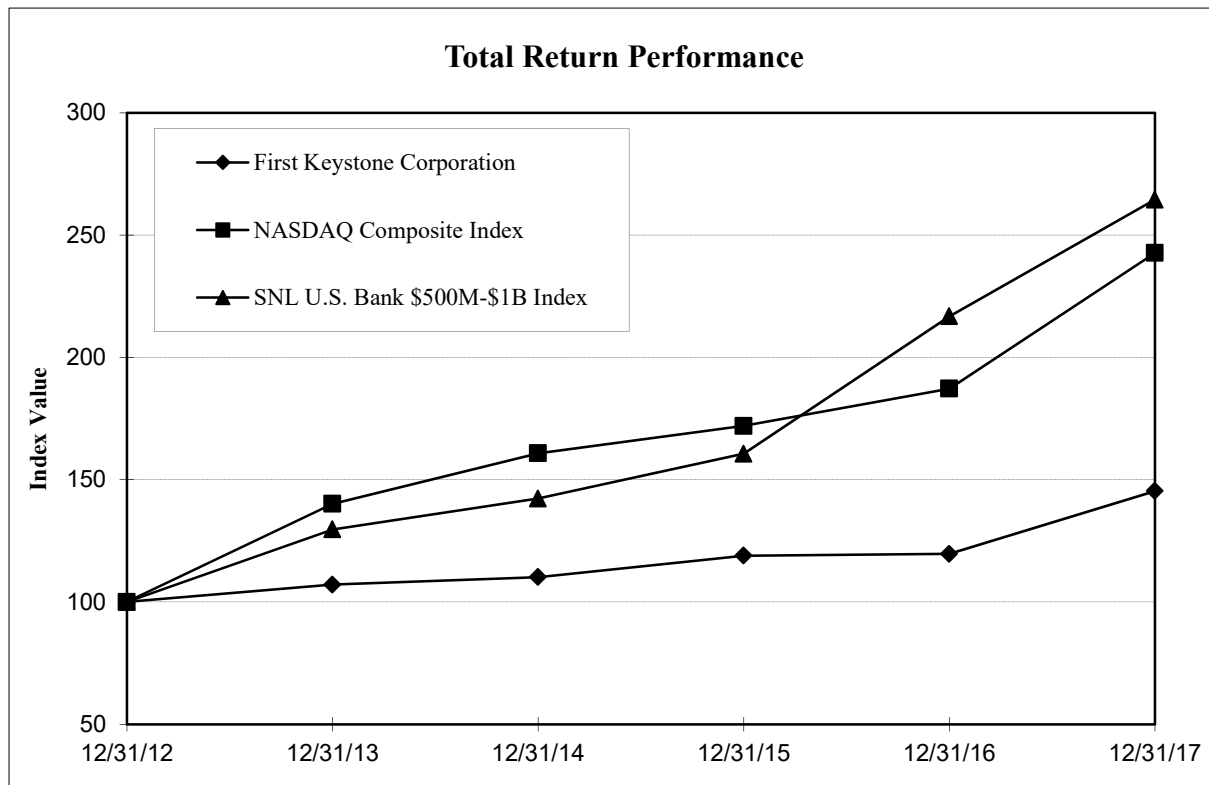
## PERFORMANCE GRAPH

The following graph and table compare the cumulative total shareholder return on the Corporation's common stock during the period December 31, 2012, through and including December 31, 2017, with:

- The cumulative total return for all common stocks listed on the NASDAQ stock market, and
- The cumulative total return for all banks in SNL's universe trading on a major exchange (NYSE, NYSE MKT, NASDAQ) with \$500M to \$1B in Assets.

The comparison assumes \$100 was invested on December 31, 2012, in the Corporation's common stock and in each of the indices below and assumes further the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance.

### ***FIRST KEYSTONE CORPORATION***



	Period Ending					
	<u>12/31/12</u>	<u>12/31/13</u>	<u>12/31/14</u>	<u>12/31/15</u>	<u>12/31/16</u>	<u>12/31/17</u>
First Keystone Corporation	100.00	107.10	110.14	118.95	119.61	145.36
Nasdaq Composite	100.00	140.12	160.78	171.97	187.22	242.71
SNL U.S. Bank \$500M-\$1B	100.00	129.67	142.26	160.57	216.81	264.51



ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

	For the Year Ended December 31,				
	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
<b>SELECTED FINANCIAL DATA</b>					
<b>AT YEAR END:</b>					
Total assets	<b>\$ 990,121</b>	\$ 984,283	\$ 983,489	\$ 912,353	\$ 901,514
Total investment securities	<b>350,218</b>	379,641	385,267	348,722	354,770
Net loans	<b>551,910</b>	515,025	509,871	481,071	439,999
Total deposits	<b>778,146</b>	725,982	720,598	661,562	690,075
Total long-term borrowings	<b>65,000</b>	75,116	70,232	65,339	40,429
Total stockholders' equity	<b>116,719</b>	109,685	108,438	106,271	96,351
<b>SELECTED OPERATING DATA:</b>					
Interest income	<b>\$ 32,268</b>	\$ 31,643	\$ 31,711	\$ 31,019	\$ 30,961
Interest expense	<b>6,548</b>	5,282	4,966	4,452	4,954
Net interest income	<b>25,720</b>	26,361	26,745	26,567	26,007
Provision for loan losses	<b>267</b>	2,083	2,277	433	1,372
Net interest income after provision for loan losses	<b>25,453</b>	24,278	24,468	26,134	24,635
Non-interest income	<b>6,171</b>	7,387	7,697	7,902	7,805
Non-interest expense	<b>21,521</b>	20,348	21,022	21,208	19,942
Income before income tax expense	<b>10,103</b>	11,317	11,143	12,828	12,498
Income tax expense	<b>1,455</b>	1,845	1,971	2,617	2,225
Net income	<b><u>\$ 8,648</u></b>	<u>\$ 9,472</u>	<u>\$ 9,172</u>	<u>\$ 10,211</u>	<u>\$ 10,273</u>
<b>PER SHARE DATA:</b>					
Net income	<b>\$ 1.52</b>	\$ 1.68	\$ 1.64	\$ 1.84	\$ 1.87
Dividends	<b>1.08</b>	1.08	1.08	1.05	1.04
<b>PERFORMANCE RATIOS:</b>					
Return on average assets	<b>0.86%</b>	0.96%	0.96%	1.13%	1.23%
Return on average equity	<b>7.54%</b>	8.23%	8.43%	9.90%	10.12%
Dividend payout	<b>71.05%</b>	64.30%	65.79%	56.95%	55.64%
Average equity to average assets	<b>11.45%</b>	11.68%	11.40%	11.45%	12.10%

ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of Management’s Discussion and Analysis of First Keystone Corporation, a bank holding company (the “Corporation”), and its wholly owned subsidiary, First Keystone Community Bank (the “Bank”), is to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data contained herein. Refer to Forward Looking Statements on page 1 for detailed information.

**RESULTS OF OPERATIONS**

*Year Ended December 31, 2017 Versus Year Ended December 31, 2016*

Net income decreased to \$8,648,000 for the year ended December 31, 2017, as compared to \$9,472,000 for the prior year, a decrease of 8.7%. Earnings per share, both basic and diluted, for 2017 was \$1.52 as compared to \$1.68 in 2016, a decrease of 9.5%. Dividends per share for 2017 and 2016 were \$1.08. The Corporation’s return on average assets was 0.86% in 2017 and 0.96% in 2016. Return on average equity decreased to 7.54% in 2017 from 8.23% in 2016. Total interest income in 2017 amounted to \$32,268,000, an increase of \$625,000 or 2.0% from 2016. Total interest expense of \$6,548,000 increased \$1,266,000 or 24.0% from 2016. The majority of this increase related to higher interest bearing deposit balances during the year in 2017.

Net interest income, as indicated below in Table 1, decreased by \$641,000 or 2.4% to \$25,720,000 for the year ended December 31, 2017. The Corporation’s net interest income on a fully tax equivalent basis decreased by \$119,000, or 0.4% to \$28,620,000 in 2017 as compared to \$28,739,000 in 2016.

*Year Ended December 31, 2016 Versus Year Ended December 31, 2015*

Net income increased to \$9,472,000 for the year ended December 31, 2016, as compared to \$9,172,000 for the prior year, an increase of 3.3%. Earnings per share, both basic and diluted, for 2016 was \$1.68 as compared to \$1.64 in 2015, an increase of 2.4%. Dividends per share for 2016 and 2015 were \$1.08. The Corporation’s return on average assets was 0.96% in 2016 and 2015. Return on average equity decreased to 8.23% in 2016 from 8.43% in 2015. Total interest income in 2016 amounted to \$31,643,000, a decrease of \$68,000 or 0.2% from 2015. Total interest expense of \$5,282,000 increased \$316,000 or 6.4% from 2015. The majority of this increase related to higher interest bearing deposit balances during the year in 2016.

Net interest income, as indicated below in Table 1, decreased by \$384,000 or 1.4% to \$26,361,000 for the year ended December 31, 2016. The Corporation’s net interest income on a fully tax equivalent basis decreased by \$108,000, or 0.4% to \$28,739,000 in 2016 as compared to \$28,847,000 in 2015.

**Table 1 — Reconciliation of Taxable Equivalent Net Interest Income**

(Dollars in thousands)

	<u>2017/2016</u>			<u>2016/2015</u>			
		<u>Increase/(Decrease)</u>			<u>Increase/(Decrease)</u>		
	<u>2017</u>	<u>Amount</u>	<u>%</u>	<u>2016</u>	<u>Amount</u>	<u>%</u>	<u>2015</u>
Interest Income	\$ 32,268	\$ 625	2.0	\$ 31,643	\$ (68)	(0.2)	\$31,711
Interest Expense	<u>6,548</u>	<u>1,266</u>	24.0	<u>5,282</u>	316	6.4	4,966
Net Interest Income	<u>25,720</u>	<u>(641)</u>	<u>(2.4)</u>	<u>26,361</u>	<u>(384)</u>	<u>(1.4)</u>	26,745
Tax Equivalent Adjustment	<u>2,900</u>	<u>522</u>	22.0	<u>2,378</u>	276	13.1	2,102
Net Interest Income (fully tax equivalent)	<u>\$ 28,620</u>	<u>\$ (119)</u>	<u>(0.4)</u>	<u>\$ 28,739</u>	<u>\$ (108)</u>	<u>(0.4)</u>	<u>\$28,847</u>

**Table 2 — Average Balances, Rates and Interest Income and Expense***(Dollars in thousands)*

	2017			2016			2015		
	<u>Average Balance</u>	<u>Interest</u>	<u>Yield/Rate</u>	<u>Average Balance</u>	<u>Interest</u>	<u>Yield/Rate</u>	<u>Average Balance</u>	<u>Interest</u>	<u>Yield/Rate</u>
<b>Interest Earning Assets:</b>									
<b>Loans:</b>									
Commercial, net <sup>1,2,4</sup>	\$ 94,075	\$ 3,146	3.34%	\$ 82,924	\$ 2,868	3.46%	\$ 82,591	\$ 2,814	3.41%
Real Estate <sup>1,2</sup>	435,944	18,807	4.31%	429,205	18,495	4.31%	421,578	18,259	4.33%
Consumer, net <sup>1,4</sup>	6,035	506	8.38%	6,016	492	8.18%	5,436	441	8.11%
Fees on Loans	—	598	0%	—	565	0%	—	629	0%
Total Loans <sup>5</sup>	<u>536,054</u>	<u>23,057</u>	<u>4.30%</u>	<u>518,145</u>	<u>22,420</u>	<u>4.33%</u>	<u>509,605</u>	<u>22,143</u>	<u>4.35%</u>
<b>Investment Securities:</b>									
Taxable	200,943	4,351	2.17%	243,326	5,572	2.29%	258,320	6,526	2.53%
Tax-Exempt <sup>1,3</sup>	<u>181,698</u>	<u>7,437</u>	<u>4.09%</u>	<u>140,605</u>	<u>5,739</u>	<u>4.08%</u>	<u>105,974</u>	<u>4,697</u>	<u>4.43%</u>
Total Investment Securities	<u>382,641</u>	<u>11,788</u>	<u>3.08%</u>	<u>383,931</u>	<u>11,311</u>	<u>2.95%</u>	<u>364,294</u>	<u>11,223</u>	<u>3.08%</u>
Restricted Investment in Bank Stocks	5,847	289	4.94%	5,245	253	4.82%	5,767	415	7.20%
Interest-Bearing Deposits in Other Banks	<u>2,637</u>	<u>34</u>	<u>1.29%</u>	<u>3,316</u>	<u>37</u>	<u>1.12%</u>	<u>2,226</u>	<u>32</u>	<u>1.44%</u>
Total Other Interest Earning Assets	<u>8,484</u>	<u>323</u>	<u>3.81%</u>	<u>8,561</u>	<u>290</u>	<u>3.39%</u>	<u>7,993</u>	<u>447</u>	<u>5.59%</u>
Total Interest Earning Assets	<u>927,179</u>	<u>35,168</u>	<u>3.79%</u>	<u>910,637</u>	<u>34,021</u>	<u>3.74%</u>	<u>881,892</u>	<u>33,813</u>	<u>3.83%</u>
<b>Non-Interest Earning Assets:</b>									
Cash and Due From Banks	8,294			8,119			7,648		
Allowance for Loan Losses	(7,445)			(7,136)			(6,694)		
Premises and Equipment	19,171			19,686			20,426		
Other Assets	<u>54,786</u>			<u>53,783</u>			<u>51,321</u>		
Total Non-Interest Earning Assets	<u>74,806</u>			<u>74,452</u>			<u>72,701</u>		
Total Assets	<u>\$1,001,985</u>			<u>\$ 985,089</u>			<u>\$ 954,593</u>		
<b>Interest Bearing Liabilities:</b>									
Savings, NOW Accounts, and Money Markets	\$ 410,094	\$ 1,700	0.41%	\$ 423,037	\$ 1,139	0.27%	\$ 391,179	\$ 926	0.24%
Time Deposits	197,128	2,532	1.28%	186,182	2,286	1.23%	192,177	2,232	1.16%
Securities Sold U/A to Repurchase	21,872	89	0.41%	22,218	59	0.26%	21,221	53	0.25%
Short-Term Borrowings	64,840	755	1.16%	44,192	259	0.59%	60,549	212	0.35%
Long-Term Borrowings	68,180	1,472	2.16%	72,992	1,539	2.11%	69,837	1,543	2.21%
Federal Funds Purchased	—	—	0%	—	—	0%	—	—	0%
Total Interest Bearing Liabilities	<u>762,114</u>	<u>6,548</u>	<u>0.86%</u>	<u>748,621</u>	<u>5,282</u>	<u>0.71%</u>	<u>734,963</u>	<u>4,966</u>	<u>0.68%</u>
<b>Non-Interest Bearing Liabilities:</b>									
Demand Deposits	118,621			111,315			101,063		
Other Liabilities	6,498			10,048			9,725		
Stockholders' Equity	<u>114,752</u>			<u>115,105</u>			<u>108,842</u>		
Total Liabilities/Stockholders' Equity	<u>\$1,001,985</u>			<u>\$ 985,089</u>			<u>\$ 954,593</u>		
Net Interest Income Tax Equivalent		<u>\$28,620</u>			<u>\$28,739</u>			<u>\$28,847</u>	
Net Interest Spread			2.93%			3.03%			3.15%
Net Interest Margin			3.09%			3.16%			3.27%

<sup>1</sup>Tax-exempt income has been adjusted to a tax equivalent basis using an incremental rate of 34%, and statutory interest expense disallowance.<sup>2</sup>Includes tax equivalent adjustments on tax-free municipal loans of \$442,000, \$468,000, and \$536,000 for years 2017, 2016, and 2015, respectively.<sup>3</sup>Includes tax equivalent adjustments on tax-free municipal securities of \$2,458,000, \$1,910,000, and \$1,566,000 for years 2017, 2016, and 2015, respectively.<sup>4</sup>Installment loans are stated net of unearned interest.<sup>5</sup>Average loan balances include non-accrual loans. Interest income on non-accrual loans is not included.

## NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income. Net interest income is the difference between interest income on earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, including deposits and other borrowings. The amount of interest income is dependent upon both the volume of earning assets and the level of interest rates. In addition, the volume of non-performing loans affects interest income. The amount of interest expense varies with the amount of funds needed to support earning assets, interest rates paid on deposits and borrowed funds, and finally, the level of interest free deposits.

Table 2 on the preceding page provides a summary of average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and interest expense as well as average tax equivalent rates earned and paid as of year-end 2017, 2016 and 2015.

The yield on earning assets was 3.79% in 2017, 3.74% in 2016, and 3.83% in 2015. The rate paid on interest bearing liabilities was 0.86% in 2017, 0.71% in 2016, and 0.68% in 2015. This resulted in a decrease in our net interest spread to 2.93% in 2017, as compared to 3.03% in 2016 and 3.15% in 2015.

As Table 2 illustrates, net interest margin, which is interest income less interest expense divided by average earning assets, was 3.09% in 2017 as compared to 3.16% in 2016 and 3.27% in 2015. Net interest margins are presented on a tax-equivalent basis. In 2017, yield on earning assets increased by 0.05%, from 3.74% to 3.79% while the rate paid on interest bearing liabilities increased 0.15%. As loans were repaid and refinanced, the principal balances were reinvested at lower, current rates. This was the primary cause of the lower yield on loans. The primary reason for the increased yield in the investment portfolio was due to the additional tax-free bond purchases during 2017. Savings, NOW and money market interest expense increased as a result of the Bank branded Keystone Rewards suite of high interest rewards checking and savings accounts. Average short-term borrowings increased \$20,648,000 while the average rate paid on these borrowings increased by 0.57% from 0.59% to 1.16%. Interest income exempt from federal tax was \$5,875,000 in 2017, \$4,767,000 in 2016, and \$4,203,000 in 2015. Interest income exempt from federal tax increased due to purchases of tax-exempt securities. Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 34%.

The decline in our net interest margin came from higher interest bearing liability yields in 2017 and slightly lower earning asset yields in 2016. Fully tax equivalent net interest income decreased from 2016 to 2017 by \$119,000 or 0.4% to \$28,620,000. This occurred while the level of average earning assets increased by 1.8%. The Corporation's net interest margin was under pressure when short-term interest rates started to rise since the Corporation continues to be liability sensitive. There will be more liabilities, including deposits, repricing than earning assets (loans and investments). To negate the potential impact of a decreasing net interest margin, the Corporation will continue to focus on attracting lower cost core deposits such as checking, savings and money market accounts thereby reducing its dependence on higher priced certificates of deposit and short-term borrowings.

Throughout 2017, the Federal Reserve increased the federal-funds rate by 0.75%, making the target range between 1.25% and 1.50%. The impact to the Bank's net interest margin has been a slight tightening. Short-term borrowing costs have increased in a similar fashion. However, there has been little to no change to deposit funding costs. Asset yields are starting to pick up across the curve. The Bank will continue to monitor short-term rate increases in 2018 as well as the slope and position of the yield curve. A steady and continued path of rising interest rates will have an initial negative effect on net interest margin, based on our asset/liability management model. However, indications are that higher interest rates, accompanied by a positively sloped yield curve would serve to increase our net interest margin in the long-term.

Table 3 sets forth changes in interest income and interest expense for the periods indicated for each category of interest earning assets and interest bearing liabilities. Information is provided on changes attributable to (i) changes in volume (changes in average volume multiplied by prior rate); (ii) changes in rate (changes in average rate multiplied by prior average volume); and, (iii) changes in rate and volume (changes in average volume multiplied by change in average rate).

In 2017, the decrease in net interest income on a fully tax equivalent basis of \$119,000 resulted from an increase in volume of \$1,384,000 and a decrease of \$1,503,000 due to changes in rate. In 2016, the decrease in net interest income on a fully tax equivalent basis of \$108,000 resulted from an increase in volume of \$1,485,000 and a decrease of \$1,593,000 due to changes in rate.

**Table 3 — Rate/Volume Analysis***(Dollars in thousands)*

	<u>2017 COMPARED TO 2016</u>			<u>2016 COMPARED TO 2015</u>		
	<u>VOLUME</u>	<u>RATE</u>	<u>NET</u>	<u>VOLUME</u>	<u>RATE</u>	<u>NET</u>
Interest Income:						
Loans, Net	\$ 775	\$ (138)	\$ 637	\$ 371	\$ (94)	\$ 277
Taxable Investment Securities	(971)	(250)	(1,221)	(379)	(575)	(954)
Tax-Exempt Investment Securities	1,677	21	1,698	1,535	(493)	1,042
Restricted Investment in Bank Stocks	29	7	36	(38)	(124)	(162)
Other	(8)	5	(3)	16	(11)	5
<b>Total Interest Income</b>	<b>\$ 1,502</b>	<b>\$ (355)</b>	<b>\$ 1,147</b>	<b>\$ 1,505</b>	<b>\$ (1,297)</b>	<b>\$ 208</b>
Interest Expense						
Savings, NOW and Money Markets	\$ (35)	\$ 596	\$ 561	\$ 75	\$ 138	\$ 213
Time Deposits	134	112	246	(70)	124	54
Securities Sold U/A to Repurchase	(1)	31	30	2	4	6
Short-Term Borrowings	121	375	496	(57)	104	47
Long-Term Borrowings	(101)	34	(67)	70	(74)	(4)
Total Interest Expense	118	1,148	1,266	20	296	316
<b>Net Interest Income</b>	<b>\$ 1,384</b>	<b>\$ (1,503)</b>	<b>\$ (119)</b>	<b>\$ 1,485</b>	<b>\$ (1,593)</b>	<b>\$ (108)</b>

The change in interest due to both volume and yield/rate has been allocated to change due to volume and change due to yield/rate in proportion to the absolute value of the change in each. Balances on non-accrual loans are included for computational purposes. Interest income on non-accrual loans is not included.

### PROVISION FOR LOAN LOSSES

For the year ended December 31, 2017, the provision for loan losses was \$267,000 as compared to \$2,083,000 for 2016 and \$2,277,000 for 2015. The decrease in the provision for loan losses in 2017 as compared to 2016 and 2015 resulted from the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, economic conditions, other relevant factors, and individually significant charge-offs of \$943,000 and \$1,355,000 in 2016 and 2015, respectively, as discussed below and in the Allowance For Loan Losses section on page 36. Net charge-offs by the Corporation for the fiscal years ended December 31, 2017, 2016 and 2015 were \$137,000, \$1,465,000, and \$1,928,000, respectively. See Allowance for Loan Losses on page 36 for further discussion.

Gross charge-offs amounted to \$333,000 at December 31, 2017, as compared to \$1,494,000 at December 31, 2016 and \$2,016,000 at December 31, 2015. The increased level of charge-offs in 2015 was due to a large charge-off in the amount of \$1,355,000 on a Commercial Real Estate loan to a student housing holding company. The loan was moved to non-accrual status during the third quarter of 2015 due to uncertainty regarding the collectability of principal and interest based on the borrower's failure to achieve stabilization and meet projected occupancy rates. The charge-off was completed during the fourth quarter of 2015 because the underlying value of the collateral supporting the loan was not sufficient to cover the loan balance. At that time, the loan was charged down to the estimated value of the supporting collateral less costs to sell. The increased level of charge-offs continued from 2015 to 2016 because a large charge-off in the amount of \$943,000 was completed during the third quarter of 2016 on a Commercial Real Estate troubled debt restructuring to a student housing holding company due to uncertainty regarding the collectability of principal and interest based on the borrower's failure to achieve stabilization and meet projected occupancy rates. As the underlying value of the collateral was not sufficient to cover the loan balance, the loan was charged down to the estimated value of the supporting collateral less costs to sell. The large charge-offs contributed to the increased balance of net charge-offs and provision for loan losses in 2016 and 2015 but were not indicative of a significant change in asset quality in the overall loan portfolio, as net charge-offs and the provision for loan losses decreased significantly for the year ended December 31, 2017. See Table 10 – Analysis of Allowance for Loan Losses for further details.

The allowance for loan losses as a percentage of average loans outstanding was 1.40% as of December 31, 2017, 1.42% as of December 31, 2016 and 1.32% as of December 31, 2015.

On a quarterly basis, management performs, and the Corporation's Audit Committee and the Board of Directors review a detailed analysis of the adequacy of the allowance for loan losses. This analysis includes an evaluation of credit risk concentration, delinquency trends, past loss experience, current economic conditions, composition of the loan portfolio, classified loans and other relevant factors.

The Corporation will continue to monitor its allowance for loan losses and make future adjustments to the allowance through the provision for loan losses as conditions warrant. Although the Corporation believes that the allowance for loan losses is adequate to provide for losses inherent in the loan portfolio, there can be no assurance that future losses will not exceed the estimated amounts or that additional provisions will not be required in the future.

The Corporation is subject to periodic regulatory examination by the Pennsylvania Department of Banking and Securities and the FDIC. As part of the examination, the regulators will assess the adequacy of the Corporation's allowance for loan losses and may include factors not considered by the Corporation. In the event that a regulatory examination results in a conclusion that the Corporation's allowance for loan losses is not adequate, the Corporation may be required to increase its provision for loan losses.

## **NON-INTEREST INCOME**

Non-interest income is derived primarily from service charges and fees, ATM and debit card income, trust department revenue, income on bank owned life insurance, gains on sales of mortgage loans and other miscellaneous income. In addition, net investment securities gains and losses also impact total non-interest income. Table 4 provides the yearly non-interest income by category, along with the amount, dollar changes, and percentage of change.

Non-interest income through December 31, 2017 was \$6,171,000, a decrease of 16.5%, or \$1,216,000, from 2016. Table 4 provides the major categories of non-interest income and each respective change comparing the last three years. The majority of the 2017 decrease was due to decreases in net investment securities gains and gains from life insurance proceeds.

During 2017, the Corporation recorded a net gain of \$938,000 from the sales of securities in its investment portfolio, a decrease of \$826,000 from 2016. The Bank has taken gains and losses in the portfolio in 2017 in an effort to increase interest income through partial reinvestment in the investment portfolio and to fund growth in the loan portfolio. In 2015, gains totaled \$2,131,000, while in 2016 they were \$1,764,000. These gains resulted from the normal readjustment process within the portfolio.

Gains on sales of mortgage loans provided income of \$316,000 in 2017 as compared to \$358,000 in 2016 and \$548,000 in 2015. The decrease in gains on sales of mortgage loans in 2017 was due to a decrease in loans originated with the intent to sell and volume of loans sold. In 2017, the Bank originated \$20,843,000 in residential mortgage loans, of which \$11,906,000 were originated with the intent to sell. This compared unfavorably to 2016 when the Bank originated \$29,168,000 in residential mortgage loans, of which \$12,928,000 were originated with the intent to sell. The Corporation continues to service the majority of mortgages which are sold. This servicing income provides an additional source of non-interest income on an ongoing basis.

Service charges and fees increased by \$17,000 in 2017 as compared to 2016, or 1.0% due to an increase in per item overdraft fees and certain other deposit account fees. In addition, ATM and debit card income increased \$92,000 or 7.1%. Service charges and fees increased \$13,000 in 2016 as compared to 2015, primarily due to an increase in per item overdraft fees and certain other deposit account fees.

During the third quarter of 2016, the Corporation received \$458,000 in tax-free claims income from life insurance proceeds as the result of a death benefit paid on a life insurance policy covering one of its former employees that remained an insured person by the Corporation's bank-owned life insurance program following her separation of employment.

Other income, consisting primarily of safe deposit box rentals, income from the sale of non-deposit investment products, and miscellaneous fees, decreased \$24,000, or 10.6% in 2017 and decreased \$268,000 or 54.3% in 2016. The decrease in other income in 2016 was the result of a decline in retail investment activity.

**Table 4 — Non-Interest Income***(Dollars in thousands)*

	2017/2016			2016/2015			
	Increase/(Decrease)			Increase/(Decrease)			
	2017	Amount	%	2016	Amount	%	2015
Trust department	\$ 880	\$ 40	4.8	\$ 840	\$ (37)	(4.2)	\$ 877
Service charges and fees	1,803	17	1.0	1,786	13	0.7	1,773
Bank owned life insurance income	636	(15)	(2.3)	651	(13)	(2.0)	664
ATM and debit card income	1,396	92	7.1	1,304	80	6.5	1,224
Gains on sales of mortgage loans	316	(42)	(11.7)	358	(190)	(34.7)	548
Impairment charges on equity securities	—	—	N/A	—	14	(100.0)	(14)
Gains from life insurance proceeds	—	(458)	(100.0)	458	458	N/A	—
Other	202	(24)	(10.6)	226	(268)	(54.3)	494
Subtotal	5,233	(390)	(6.9)	5,623	57	1.0	5,566
Net investment securities gains	938	(826)	(46.8)	1,764	(367)	(17.2)	2,131
Total	<u>\$ 6,171</u>	<u>\$ (1,216)</u>	<u>(16.5)</u>	<u>\$ 7,387</u>	<u>\$ (310)</u>	<u>(4.0)</u>	<u>\$ 7,697</u>

**NON-INTEREST EXPENSE**

Total non-interest expense amounted to \$21,521,000, an increase of \$1,173,000, or 5.8% in 2017 as compared to a decrease of \$674,000, or 3.2% in 2016. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to \$11,170,000 or 51.9% of total non-interest expense in 2017 and 51.5% in 2016. Salaries and employee benefits increased \$686,000, or 6.5% in 2017 and decreased \$528,000, or 4.8% in 2016. The increase in 2017 was due to the bank adding new sales positions in the commercial and residential mortgage lending areas and additional staff, as well as increased costs associated with employee health care. The Corporation experienced a 19.4% increase in medical insurance for its employees in 2017. The number of full time equivalent employees was 191 as of December 31, 2017, 182 as of December 31, 2016, and 189 as of December 31, 2015.

Net occupancy expense increased \$30,000, or 1.7% in 2017 as compared to a decrease of \$66,000, or 3.6% in 2016. Net furniture and equipment and computer expense increased \$62,000, or 4.1% in 2017 compared to an increase of \$85,000, or 5.9% in 2016. The increase in 2017 was due to higher software maintenance costs stemming from new deposits, credit and loans software implemented towards the end of 2016.

Professional services increased \$209,000, or 31.8% in 2017 as compared to an increase of \$48,000, or 7.9% in 2016. The increase in 2017 was due to pricing increases associated with audit and tax services, out of scope audit work associated with the 2016 annual report and additional fees incurred for financial services department analysis and consulting.

Pennsylvania shares tax expense increased \$42,000, or 6.0% in 2017 as compared to a decrease of \$12,000, or 1.7% in 2016. FDIC insurance expense decreased \$161,000, or 33.4% in 2017 as compared to a decrease of \$50,000, or 9.4% in 2016. The decrease was due to changes in assessment methodologies implemented by the FDIC in the second half of 2016. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates.

ATM and debit card fees expense increased \$46,000, or 7.1% in 2017 as compared to an increase of \$51,000, or 8.5% in 2016. The increase in 2017 was primarily due to multiple issues of fraud losses on debit cards throughout the year. Data processing fees increased \$43,000, or 7.7% in 2017 as compared to a decrease of \$14,000, or 2.5% in 2016. The increase in 2017 was primarily due to an increase in software related data processing fees associated with the rollout of new rewards checking and savings products.

Foreclosed assets held for resale expense amounted to \$135,000 in 2017, \$289,000 in 2016 and \$111,000 in 2015. The Corporation incurred costs associated with the maintenance and sales of twelve foreclosed properties in 2015, sixteen foreclosed properties in 2016 and twelve properties in 2017. The decrease in expense in 2017 was due to lower maintenance costs and sales expenses in the early part of 2017 and the net effect of gains on sold OREO properties during the third quarter of 2017.

Advertising expense increased \$140,000, or 35.9% in 2017 as compared to a decrease of \$86,000, or 18.1% in 2016. The increase in 2017 was primarily due to increased media advertising for the rollout of new rewards checking and savings products.

Other non-interest expense increased \$230,000, or 8.0% in 2017 as compared to a decrease of \$280,000, or 8.9% in 2016. The increase in 2017 was due to an increase in Kasasa branded deposit product fees incurred as a result of discontinued services, an increase in collections fees attributable to increased legal costs, promotional expenses related to coupons for residential appraisals and closing costs associated with the sale of a property.

The overall level of non-interest expense remains low, relative to the Bank's peers (community banks from \$500 million to \$1 billion in assets). In fact, the Bank's total non-interest expense was 2.15% of average assets in 2017 and 2.07% in 2016. The Bank's non-interest expense as a percentage of average assets places the Bank among the leaders in its peer financial institution categories in controlling non-interest expense.

**Table 5 — Non-Interest Expense**

(Dollars in thousands)

	2017/2016			2016/2015			
	Increase/(Decrease)			Increase/(Decrease)			
	2017	Amount	%	2016	Amount	%	2015
Salaries and employee benefits	\$11,170	\$ 686	6.5	\$10,484	\$ (528)	(4.8)	\$11,012
Occupancy, net	1,777	30	1.7	1,747	(66)	(3.6)	1,813
Furniture and equipment	569	14	2.5	555	(47)	(7.8)	602
Computer expense	1,025	48	4.9	977	132	15.6	845
Professional services	866	209	31.8	657	48	7.9	609
Pennsylvania shares tax	742	42	6.0	700	(12)	(1.7)	712
FDIC Insurance	321	(161)	(33.4)	482	(50)	(9.4)	532
ATM and debit card fees	697	46	7.1	651	51	8.5	600
Data processing fees	600	43	7.7	557	(14)	(2.5)	571
Foreclosed assets held for resale	135	(154)	(53.3)	289	178	160.4	111
Advertising	530	140	35.9	390	(86)	(18.1)	476
Other	3,089	230	8.0	2,859	(280)	(8.9)	3,139
Total	<u>\$21,521</u>	<u>\$1,173</u>	5.8	<u>\$20,348</u>	<u>\$ (674)</u>	(3.2)	<u>\$21,022</u>

## INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2017, was \$1,455,000 as compared to \$1,845,000 and \$1,971,000 for the years ended December 31, 2016 and 2015, respectively. The effective income tax rate was 14.4% in 2017, 16.3% in 2016, and 17.7% in 2015. The decrease in the effective tax rate for 2017 was due to a net increase in tax-exempt income from investments in state and local units of government, an increase in tax credits from investments in low-income housing partnerships, and a decrease in net gains on sales of investment securities. The Corporation looks to maximize its tax-exempt income derived from both tax-free loans and tax-free municipal securities. In December 2017, the government passed major tax reform legislation in the Tax Cuts and Jobs Act of 2017. The Act reduces the Corporation's income tax rate from 34% to 21% and eliminates the alternative minimum tax, effective January 1, 2018. As a result of the reduction in the income tax rate, 2017 income tax expense includes an additional income tax provision of \$379,000 related to a reduction in the carrying value of the net deferred tax asset. Management expects the Corporation's income tax provision will be significantly lower in 2018 and on an ongoing basis as a result of the lower tax rate.

## FINANCIAL CONDITION

### GENERAL

Total assets increased to \$990,121,000 at year-end 2017, an increase of 0.6% from year-end 2016. Total assets as of December 31, 2016 were \$984,283,000, an increase of 0.1% over 2015.

Total investments decreased \$29,419,000 or 7.7% to \$350,218,000 as of December 31, 2017.

Net loans increased in 2017 from \$515,025,000 to \$551,910,000, a 7.2% increase. Loan demand grew in 2017 as the Bank added loans in the commercial and industrial and commercial real estate categories. Net loans in 2016 increased from 2015 by \$5,154,000 or 1.0%.

The cash surrender value of bank owned life insurance totaled \$22,354,000 at December 31, 2017, an increase of \$636,000 or 2.9% from 2016.



Investments in low-income housing partnerships were \$2,626,000 at year-end 2017, an increase of 2.8% from year-end 2016. The Bank became a limited partner in a new real estate venture during 2015 with an initial investment of \$590,000, a second installment of \$1,178,000 in 2016, third and fourth installments in 2017 of \$168,000 and \$84,000, respectively, and a commitment of an additional capital contribution up to \$85,000 over the life of the project. Investing in low-income housing real estate ventures enables the Bank to recognize tax credits and satisfy Community Reinvestment Act initiatives.

As of December 31, 2017, total deposits amounted to \$778,146,000, an increase of 7.2% from 2016, while total deposits as of year-end 2016 amounted to \$725,982,000, an increase of 0.7% from 2015. The increase in 2017 was primarily due to the issuance of several large jumbo certificates to a municipal depositor, and the deposit of funds by municipal depositors through normal, seasonal generation of tax revenues. Core deposits, which include demand deposits and interest bearing demand deposits (NOWs), money market accounts, savings accounts, and time deposits of individuals, continue to be the Corporation's most significant source of funds.

The Corporation continues to maintain and manage its asset growth. The Corporation's strong equity capital position provides an opportunity to further leverage its asset growth. Borrowings decreased in 2017 by \$53,110,000 and decreased in 2016 by \$6,365,000.

Total stockholders' equity increased to \$116,719,000 at December 31, 2017, an increase of \$7,034,000 or 6.4% over 2016. Total stockholders' equity increased to \$109,685,000 at December 31, 2016, an increase of \$1,247,000 or 1.1% over 2015.

## **SEGMENT REPORTING**

Currently, management measures the performance and allocates the resources of the Corporation as a single segment.

## **EARNING ASSETS**

Earning assets are defined as those assets that produce interest income. By maintaining a healthy asset utilization rate, i.e., the volume of earning assets as a percentage of total assets, the Corporation maximizes income. The earning asset ratio (average interest earning assets divided by average total assets) equaled 92.5% for 2017, compared to 92.4% for 2016 and 2015, respectively. This indicates that the management of earning assets is a priority and non-earning assets, primarily cash and due from banks, fixed assets and other assets, are maintained at minimal levels. The primary earning assets are loans and investment securities.

## **INVESTMENT SECURITIES**

The Corporation uses investment securities to not only generate interest and dividend revenue, but also to help manage interest rate risk and to provide liquidity to meet operating cash needs.

The investment portfolio has been allocated between securities available-for-sale and securities held-to-maturity. No investment securities were established in a trading account. Available-for-sale securities decreased \$29,419,000 or 7.7% to \$350,218,000 in 2017. Available-for-sale securities decreased \$5,604,000 or 1.5% to \$379,637,000 in 2016. At December 31, 2017, the net unrealized gain, net of the tax effect, on these securities was \$1,826,000 and was included in stockholders' equity as accumulated other comprehensive income (loss). In 2017, held-to-maturity securities decreased \$4,000, or 100.0% to \$0 after decreasing \$22,000, or 84.6% in 2016. Table 6 provides data on the carrying value of the Corporation's investment portfolio on the dates indicated. The vast majority of investment security purchases are allocated as available-for-sale. This provides the Corporation with increased flexibility should there be a need or desire to liquidate an investment security.

The investment portfolio includes, U.S. Government corporations and agencies, corporate debt obligations, mortgage-backed securities, and obligations of state and political subdivisions, both tax-exempt and taxable. Marketable equity securities consist of common stock investments in other commercial banks and bank holding companies.

Securities available for sale may be sold as part of the overall asset and liability management process. Realized gains and losses are reflected in the results of operations on the Corporation's Consolidated Statements of Income. As of December 31, 2017, the investment portfolio does not contain any off-balance sheet derivatives or trust preferred investments.

**Table 6 — Investment Securities***(Dollars in thousands)*

	December 31,					
	2017		2016		2015	
	<u>Available for Sale<sup>1</sup></u>	<u>Held to Maturity<sup>2</sup></u>	<u>Available for Sale<sup>1</sup></u>	<u>Held to Maturity<sup>2</sup></u>	<u>Available for Sale<sup>1</sup></u>	<u>Held to Maturity<sup>2</sup></u>
U.S. Treasury securities	\$ —	\$ —	\$ 1,010	\$ —	\$ 1,021	\$ —
U. S. Government corporations and agencies	104,093	—	131,877	4	134,066	26
Obligations of state and political subdivisions	215,522	—	211,134	—	200,314	—
Corporate debt securities	28,971	—	33,976	—	47,833	—
Marketable equity securities	1,632	—	1,640	—	2,007	—
Total	<u>\$350,218</u>	<u>\$ —</u>	<u>\$379,637</u>	<u>\$ 4</u>	<u>\$385,241</u>	<u>\$ 26</u>

<sup>1</sup>At fair value.<sup>2</sup>At amortized cost.

The amortized cost and weighted average yield of securities, by contractual maturity, are shown below at December 31, 2017. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

**Table 7 — Securities Maturity Table***(Dollars in thousands)*

	December 31, 2017					
	Available-For-Sale					Held-To-Maturity
	U.S. Treasury Securities	U.S. Government Corporations & Agencies Obligations <sup>1</sup>	Obligations of State & Political Subdivisions <sup>2</sup>	Corporate Debt Securities	Marketable Equity Securities <sup>3</sup>	U.S. Government Corporations & Agencies Obligations <sup>1</sup>
Within 1 Year:						
Amortized cost	\$ —	\$ —	\$ 1,015	\$ 532	\$ —	\$ —
Weighted average yield	—	—	2.44%	2.63%	—	—
1 - 5 Years:						
Amortized cost	—	11,851	28,738	8,310	—	—
Weighted average yield	—	2.18%	2.66%	2.51%	—	—
5 - 10 Years:						
Amortized cost	—	36,142	70,594	20,803	—	—
Weighted average yield	—	2.03%	3.12%	2.67%	—	—
After 10 Years:						
Amortized cost	—	57,241	111,396	—	740	—
Weighted average yield	—	2.44%	3.28%	—	5.87%	—
Total:						
Amortized cost	\$ —	\$ 105,234	\$ 211,743	\$ 29,645	\$ 740	\$ —
Weighted average yield	—	2.27%	3.14%	2.63%	5.87%	—

<sup>1</sup>Mortgage-backed securities are allocated for maturity reporting at their original maturity date.<sup>2</sup>Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.<sup>3</sup>Marketable equity securities are not considered to have defined maturities and are included in the after ten year category.

## LOANS

Total loans increased to \$559,397,000 as of December 31, 2017, as compared to a balance of \$522,382,000 as of December 31, 2016. Table 8 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans increased \$37,015,000, or 7.1% in 2017 compared to an increase of \$5,772,000, or 1.1% in 2016.

Steady demand for borrowing by both individuals and businesses accounted for the 7.1% increase in total loans in 2017 as compared to the 1.1% increase in total loans in 2016. Reduced demand for borrowing by businesses and the payoff of several large tax-free Commercial and Industrial loans contributed to the nominal 1.1% increase in total loans in 2016. The Commercial and Industrial portfolio increased \$15,764,000 to \$99,337,000 as of December 31, 2017, as compared to \$83,573,000 at December 31, 2016. The increase in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations totaling \$41,708,000 offset by loan payoffs of \$22,197,000 and regular principal payments. The Commercial Real Estate loan portfolio (which includes tax-free Commercial Real Estate loans) increased \$27,451,000 to \$290,970,000 as of December 31, 2017, as compared to \$263,519,000 at December 31, 2016. The increase was mainly the result of \$73,875,000 in new loan originations, offset by \$29,787,000 in loan payoffs in addition to regular principal payments and other typical amortization in the loan portfolio. Residential Real Estate loans decreased \$6,110,000 to \$162,925,000 as of December 31, 2017, as compared to \$169,035,000 at December 31, 2016. The decrease was the result of new loan originations totaling \$14,379,000, offset by loan payoffs of \$16,153,000, net loans sold of \$2,508,000 and regular principal payments. Net loans sold in the Residential Real Estate portfolio for the year ended December 31, 2017 consisted of total loans sold during the year ended December 31, 2017 of \$11,167,000, offset with loans opened and sold in the same quarter during any quarter of 2017 which amounted to \$8,659,000. The Corporation continues to originate and sell certain long-term fixed rate residential mortgage loans which conform to secondary market requirements. The Corporation derives ongoing income from the servicing of mortgages sold in the secondary market. The Corporation continues its efforts to lend to creditworthy borrowers despite the continued slow economic conditions.

Management believes that the loan portfolio is well diversified. The total commercial portfolio was \$390,307,000 at December 31, 2017. Of total loans, \$290,970,000 or 52.0% were secured by commercial real estate, primarily lessors of residential buildings and dwellings and lessors of non-residential buildings. We continue to monitor these portfolios.

The largest relationship is comprised of multiple first and second lien mortgages relating to the purchase and improvements of several existing hotels. The principal and related owners/guarantors have extensive experience in the hotel industry, owning and operating hotels in various states for over twenty-five years. At December 31, 2017, the relationship had outstanding loan balances and unused commitments of \$10,021,000. The debt is comprised of \$9,966,000 in term debt and two lines of credit totaling \$55,000. The loans are secured by commercial real estate and business assets.

The second largest relationship is comprised of various real estate entities with a mutual owner who is a related party of the bank and began real estate investment and development activities in 1989. The relationship had outstanding loan balances and unused commitments of \$9,803,000 at December 31, 2017. The individual owns a diverse mix of real estate entities which specialize in construction/development projects (which include VA clinics), leasing of commercial office space, and rental of multi-tenant residential units. This relationship is comprised of \$8,703,000 in term debt and two lines of credit totaling \$1,100,000. The relationship is well secured by first lien mortgages on income producing commercial and residential real estate, plus assignment of governmental leases and collateral pledge of cash accounts and marketable securities.

The third largest relationship consists of a large, suburban/rural public school district that provides educational services to over 5,000 students and employs approximately 750 individuals as administrative, professional, and support staff. At December 31, 2017, the relationship had outstanding balances totaling \$9,665,000 which consisted entirely of tax-free commercial term debt. The relationship is secured by business assets and the full faith, credit, and taxing power of the district.

The fourth largest relationship consists of a distributor and marketer of energy products and services including natural gas, propane, butane, and electricity. During 2017, the company undertook to partner with local banks to finance its capital needs while promoting regional economic development. At December 31, 2017, the relationship had outstanding balances of \$9,000,000 which consisted entirely of unsecured term debt. The debt will be utilized for general corporate needs, including upgrades to the company's utility distribution system that will enhance its ability to continue providing safe and reliable natural gas service.

The fifth largest relationship consists of a hotel management company that has been in operation since 1987 and successfully owns and operates seven hotels. At December 31, 2017, the relationship had outstanding balances totaling \$8,526,000, which consisted entirely of term debt. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy.

Each of the five relationships are headquartered in the Corporation's market area.

All of the above mentioned loans are performing as agreed and all are graded pass. The property securing each of the loans was appraised at the time the loan was originated. Appraisals are ordered independently of the loan approval process from appraisers on an approved list. All appraisals are reviewed internally for conformity with accepted standards of the Bank.

All loan relationships in excess of \$1,500,000 are reviewed internally and through an external loan review process on an annual basis. Such review is based upon analysis of current financial statements of the borrower, co-borrowers/guarantors, payment history, and economic conditions.

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$541,916,000 or 97.0% of gross loans are graded Pass; \$1,700,000 or 0.3% are graded Special Mention; \$15,012,000 or 2.7% are graded Substandard; and \$0 are graded Doubtful. The rating is intended to represent the best assessment of risk available at a given point in time, based upon a review of the borrower's financial statements, credit analysis, payment history with the Bank, credit history and lender knowledge of the borrower. See Note 4 — Loans and Allowance for Loan Losses for risk grading tables.

Overall, non-pass grades decreased to \$16,712,000 at December 31, 2017, as compared to \$28,417,000 at December 31, 2016. Commercial and Industrial non-pass grades decreased to \$1,344,000 as of December 31, 2017, compared to \$5,109,000 as of December 31, 2016. Commercial Real Estate non-pass grades decreased to \$13,724,000 as of December 31, 2017 as compared to \$20,041,000 as of December 31, 2016. Residential Real Estate and Consumer non-pass grades decreased to \$1,644,000 as of December 31, 2017, as compared to \$3,267,000 as of December 31, 2016.

The \$3,765,000 decrease in Commercial and Industrial non-pass grades was mainly the result of the upgrade of four loans totaling \$3,946,000 net against the downgrade of three loans totaling \$798,000, combined with regular principal payments and other normal fluctuations in the Commercial and Industrial non-pass grade portfolio during the year ended December 31, 2017. The four upgraded loans are to a manufacturer that produces parts for various industries. The loans were upgraded from Special Mention to pass-grade status during the second quarter of 2017 due to the borrower's improved financial performance and debt service capacity. The three downgraded loans are to a plastic processing company focused on non-post-consumer recycling. The loans were downgraded to Substandard and moved to non-accrual status during the first quarter of 2017 due to a downturn in revenues resulting from lower commodity prices for new plastic produced from petroleum and natural gas liquids.

The \$6,317,000 decrease in the Commercial Real Estate non-pass grade portfolio was primarily the result of several fluctuations including large upgrades to pass-grade status and significant pay-downs and pay-offs net against loans transferred to non-pass grade status and the repurchase of a portion of a non-pass grade participation loan, combined with regular principal payments and other normal activity in the Commercial Real Estate non-pass grade portfolio during the year ended December 31, 2017. One loan in the amount of \$1,086,000 to the owner of a golf course and related facilities was upgraded from Special Mention to pass-grade status during the second quarter of 2017 due to improved debt service capacity based on improved financials, stable club membership, and steady payment performance, and one loan in the amount of \$536,000 to a contractor specializing in concrete projects was upgraded from Special Mention to pass-grade status during the third quarter of 2017 due to improved financial performance as reflected by increased sales and improved cash flow and debt service capacity. Three substandard commercial real estate loans associated with a non-profit community recreation facility totaling \$1,135,000 were paid off during the year ended December 31, 2017, one special mention loan to a commercial real estate developer in the amount of \$742,000 was paid off during the fourth quarter of 2017, and one substandard commercial real estate loan to the operator of an indoor sports facility in the amount of \$500,000 was paid off during the fourth quarter of 2017. Activity associated with three loans to a developer of a residential sub-division resulted in combined pay-offs and pay-downs of \$3,712,000 during the year ended December 31, 2017; two special mention loans totaling \$2,220,000 were paid off during the first quarter of 2017 and pay-downs of \$1,492,000 were made on one of the guarantor's existing substandard loans during the year ended December 31, 2017.

A repurchase of one participant's portion of a substandard commercial real estate participation loan to a student housing holding company was completed during the third quarter of 2017; the repurchased portion totaled \$1,350,000. Two commercial real estate loans totaling \$634,000 to a plastic processing company focused on non-post-consumer recycling were downgraded to Substandard and moved to non-accrual status during the first quarter of 2017 due to a downturn in revenues resulting from lower commodity prices for new plastic produced from petroleum and natural gas liquids.

The \$1,623,000 decrease in the Residential Real Estate non-pass grade portfolio was largely the result of two loans that were upgraded to pass-grade status combined with regular principal payments and other normal fluctuations in the Residential Real Estate non-pass grade portfolio during the year ended December 31, 2017. One loan in the amount of \$669,000 to a commercial real estate developer was upgraded from Special Mention to pass-grade status during the fourth quarter of 2017 as the result of

improved payment performance. One loan in the amount of \$534,000 to the self-employed operator of a cemetery care business was upgraded from Special Mention to pass-grade status during the third quarter of 2017 due to the borrower's stable payment performance.

The Corporation continues to internally underwrite each of its loans to comply with prescribed policies and approval levels established by its Board of Directors.

The classes of the Corporation's loan portfolio net of unearned discount and net deferred loan fees and costs are summarized in Table 8.

**Table 8 — Loans**

*(Dollars in thousands)*

	December 31,				
	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
Commercial and Industrial	\$ <b>99,337</b>	\$ 83,573	\$ 85,074	\$ 64,656	\$ 60,822
Commercial Real Estate	<b>290,970</b>	263,519	259,018	253,922	225,405
Residential Real Estate	<b>162,925</b>	169,035	166,628	163,553	154,675
Consumer	<b>6,165</b>	6,255	5,890	5,330	5,616
Total Loans	<b><u>\$559,397</u></b>	<u>\$522,382</u>	<u>\$516,610</u>	<u>\$487,461</u>	<u>\$446,518</u>

The Corporation's maturity and rate sensitivity information related to the loan portfolio is summarized in Table 9.

**Table 9 — Loan Maturity and Interest Sensitivity**

**Loans by Maturity**

*(Dollars in thousands)*

	December 31, 2017			
	One Year and Less	After One Year Through Five Years	After Five Years	Total
Commercial and Industrial	\$ 21,865	\$ 38,425	\$ 39,047	\$ 99,337
Commercial Real Estate	33,675	82,918	174,377	290,970
Residential Real Estate	12,544	42,067	108,314	162,925
Consumer	1,673	3,724	768	6,165
Total	<u>\$ 69,757</u>	<u>\$ 167,134</u>	<u>\$ 322,506</u>	<u>\$ 559,397</u>

The above data represents the amount of loans receivable at December 31, 2017 which, based on remaining scheduled repayments of principal, are due in the periods indicated.

**Loans by Repricing Opportunity**

*(Dollars in thousands)*

	December 31, 2017			
	One Year and Less	After One Year Through Five Years	After Five Years	Total
Commercial and Industrial	\$ 36,020	\$ 49,019	\$ 14,298	\$ 99,337
Commercial Real Estate	78,382	183,568	29,020	290,970
Residential Real Estate	20,941	37,384	104,600	162,925
Consumer	2,825	3,328	12	6,165
Total	<u>\$ 138,168</u>	<u>\$ 273,299</u>	<u>\$ 147,930</u>	<u>\$ 559,397</u>
Loans with a fixed interest rate	\$ 40,942	\$ 89,896	\$ 132,154	\$ 262,992
Loans with a variable interest rate	97,226	183,403	15,776	296,405
Total	<u>\$ 138,168</u>	<u>\$ 273,299</u>	<u>\$ 147,930</u>	<u>\$ 559,397</u>

The above data represents the amount of loans receivable at December 31, 2017 which are due or have the opportunity to reprice in the periods indicated, based on remaining scheduled repayments of principal for fixed rate loans or date of next repricing opportunity for variable rate loans. The fixed and variable portions of the amounts of loans receivable due or repricing in the periods indicated are also summarized above.

## ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2017, the allowance for loan losses was \$7,487,000 as compared to \$7,357,000 as of December 31, 2016. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectability of the principal is unlikely. The risk characteristics of the loan portfolio are managed through various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific and general allocations together with a risk/loss analysis on various segments of the portfolio according to an internal loan review process. This assessment results in an allocated allowance. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority.

Management considers, based upon its methodology, that the allowance for loan losses is adequate to cover foreseeable future losses. However, there can be no assurance that the allowance for loan losses will be adequate to cover significant losses, if any, that might be incurred in the future.

Table 10 contains an analysis of the allowance for loan losses indicating charge-offs and recoveries by year. In 2017, net charge-offs as a percentage of average loans were 0.03% as compared to 0.28% and 0.38% in 2016 and 2015, respectively. Net charge-offs amounted to \$137,000 in 2017, \$1,465,000 in 2016, and \$1,928,000 in 2015. Net charge-offs decreased significantly in 2017 as compared to 2016 and 2015 due to large charge-offs in the Commercial Real Estate portfolio that were completed during the years ended December 31, 2016 and 2015. During the year ended December 31, 2016, charge-offs were \$1,200,000 in the Commercial Real Estate portfolio due to a large charge-off on a loan to a student housing holding company that was classified as a troubled debt restructuring. The charge-off in the amount of \$943,000 was completed during the third quarter of 2016 due to uncertainty regarding the collectability of principal and interest based on the borrower's failure to achieve stabilization and meet projected occupancy rates. As the underlying value of the collateral was not sufficient to cover the loan balance, the loan was charged down to the estimated value of the supporting collateral less costs to sell. During the year ended December 31, 2015, charge-offs were \$1,759,000 in the Commercial Real Estate portfolio due to a large charge-off on a loan to a student housing holding company. The borrower failed to achieve stabilization and meet projected occupancy rates, resulting in uncertainty regarding the collectability of principal and interest. The charge-off in the amount of \$1,355,000 was completed during the fourth quarter of 2015 to charge the loan balance down to the estimated value of the supporting collateral less costs to sell. While the large charge-offs contributed significantly to the increased balance of charge-offs in 2016 and 2015, they were not indicative of a change in the asset quality of the overall portfolio, as charge-offs in the Commercial Real Estate portfolio decreased significantly to \$189,000 for the year ended December 31, 2017. The large charge-offs in 2016 and 2015 were a deviation from the Bank's past charge-off activity.

For the year ended December 31, 2017, the provision for loan losses was \$267,000 as compared to \$2,083,000 for 2016 and \$2,277,000 for 2015. The net effect of the provision, charge-offs and recoveries increased the year-end allowance for loan losses to \$7,487,000 of which 12.7% was attributed to the Commercial and Industrial component, 54.3% attributed to the Commercial Real Estate component, 22.1% attributed to the Residential Real Estate component (primarily residential mortgages), 1.5% attributed to the Consumer component, and 9.4% being the unallocated component (refer to the activity in Note 4 — Loans and Allowance for Loan Losses on page 72). The Corporation determined that the provision for loan losses made during 2017 was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of December 31, 2017.

**Table 10 — Analysis of Allowance for Loan Losses***(Dollars in thousands)*

	Years Ended December 31,				
	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
Balance at beginning of period	\$ 7,357	\$ 6,739	\$ 6,390	\$ 6,519	\$ 5,772
Charge-offs:					
Commercial and Industrial	—	195	2	107	17
Commercial Real Estate	189	1,200	1,759	328	290
Residential Real Estate	62	61	210	209	348
Consumer	82	38	45	47	39
	<u>333</u>	<u>1,494</u>	<u>2,016</u>	<u>691</u>	<u>694</u>
Recoveries:					
Commercial and Industrial	74	9	22	31	24
Commercial Real Estate	103	—	59	81	31
Residential Real Estate	9	12	1	14	5
Consumer	10	8	6	3	9
	<u>196</u>	<u>29</u>	<u>88</u>	<u>129</u>	<u>69</u>
Net charge-offs	137	1,465	1,928	562	625
Additions charged to operations	267	2,083	2,277	433	1,372
Balance at end of period	<u>\$ 7,487</u>	<u>\$ 7,357</u>	<u>\$ 6,739</u>	<u>\$ 6,390</u>	<u>\$ 6,519</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	0.03%	0.28%	0.38%	0.12%	0.14%
Allowance for loan losses to average loans outstanding during the period	1.40%	1.42%	1.32%	1.36%	1.49%

It is the policy of management and the Corporation's Board of Directors to make a provision for both identified and unidentified losses inherent in its loan portfolio. A provision for loan losses is charged to operations based upon an evaluation of the potential losses in the loan portfolio. This evaluation takes into account such factors as portfolio concentrations, delinquency trends, trends of non-accrual and classified loans, economic conditions, and other relevant factors.

The loan review process, which is conducted quarterly, is an integral part of the Bank's evaluation of the loan portfolio. A detailed quarterly analysis to determine the adequacy of the Corporation's allowance for loan losses is reviewed by the Board of Directors.

With the Bank's manageable level of net charge-offs and the additions to the reserve from the provision out of operations, the allowance for loan losses as a percentage of average loans amounted to 1.40% in 2017, 1.42% in 2016 and 1.32% in 2015.

Table 11 sets forth the allocation of the Bank's allowance for loan losses by loan category and the percentage of loans in each category to the total allowance for loan losses at the dates indicated. The portion of the allowance for loan losses allocated to each loan category does not represent the total available for future losses that may occur within the loan category, since the total loan loss allowance is a valuation reserve applicable to the entire loan portfolio.

**Table 11 — Allocation of Allowance for Loan Losses***(Dollars in thousands)*

	December 31,									
	<u>2017</u>	<u>%*</u>	<u>2016</u>	<u>%*</u>	<u>2015</u>	<u>%*</u>	<u>2014</u>	<u>%*</u>	<u>2013</u>	<u>%*</u>
Commercial and Industrial	\$ 949	14.0	\$ 836	11.7	\$ 725	11.0	\$ 542	9.4	\$ 776	13.6
Commercial Real Estate	4,067	60.0	4,421	62.0	3,983	60.5	3,176	55.2	3,320	58.1
Residential Real Estate	1,656	24.4	1,777	24.9	1,777	27.0	1,928	33.5	1,565	27.4
Consumer	111	1.6	95	1.4	96	1.5	107	1.9	53	0.9
Unallocated	704	N/A	228	N/A	158	N/A	637	N/A	805	N/A
	<u>\$7,487</u>	<u>100.0</u>	<u>\$7,357</u>	<u>100.0</u>	<u>\$6,739</u>	<u>100.0</u>	<u>\$6,390</u>	<u>100.0</u>	<u>\$6,519</u>	<u>100.0</u>

\*Percentage of allocation in each category to total allocations in the Allowance for Loan Loss Analysis, excluding unallocated.

## NON-PERFORMING ASSETS

Table 12 details the Corporation's non-performing assets and impaired loans as of the dates indicated. Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against current period income. A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession that the Corporation would not otherwise consider. Modifications to loans classified as TDRs generally include reductions in contractual interest rates, principal deferments and extensions of maturity dates at a stated interest rate lower than the current market for a new loan with similar risk characteristics. While unusual, there may be instances of loan principal forgiveness. Foreclosed assets held for resale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

Total non-performing assets amounted to \$6,231,000 as of December 31, 2017, as compared to \$4,242,000 as of December 31, 2016. The economy, in particular, high unemployment/labor underutilization rate, weak job markets, unsettled fuel prices and energy costs, and the continued slowness in the housing industry had a direct effect on the Corporation's non-performing assets. The Corporation is closely monitoring its Commercial Real Estate portfolio because of the current economic environment. In particular, vacancy rates are rising, while property values in some markets have fallen. Non-accrual loans totaled \$5,090,000 as of December 31, 2017 as compared to \$2,935,000 as of December 31, 2016. The significant increase in non-accrual loans at December 31, 2017 as compared to December 31, 2016 is mainly attributable to six loans to a plastic processing company focused on non-post-consumer recycling and a related guarantor totaling \$1,519,000 that were moved to non-accrual status during the first quarter of 2017 and \$1,350,000 that was repurchased during the third quarter of 2017 on a non-accrual participation loan to a student housing holding company, combined with other normal fluctuations in the non-accrual portfolio during the year ended December 31, 2017. Foreclosed assets held for resale decreased to \$1,071,000 as of December 31, 2017 from \$1,273,000 as of December 31, 2016. Loans past-due 90 days or more and still accruing interest amounted to \$70,000 as of December 31, 2017 as compared to \$34,000 as of December 31, 2016. At December 31, 2017, loans past-due 90 days or more and still accruing interest consisted of one Residential Real Estate loan and one Commercial Real Estate loan. The borrower of the Residential Real Estate loan totaling \$20,000 has filed bankruptcy, and loan payments are currently being made through a trustee. The Commercial Real Estate loan totaling \$50,000 is well secured and in the process of collection.

Non-performing assets to total loans was 1.1% as of December 31, 2017 compared to 0.8% at December 31, 2016. Non-performing assets to total assets was 0.6% as of December 31, 2017 compared to 0.4% at December 31, 2016. The allowance for loan losses to total non-performing assets was 120.2% as of December 31, 2017 as compared to 173.5% as of December 31, 2016. Additional detail can be found in Table 12 – Non-Performing Assets and Impaired Loans and the Loans Receivable on Non-Accrual Status table in Note 4 — Loans and Allowance for Loan Losses. Asset quality is a priority and the Corporation retains a full-time loan review officer to closely track and monitor overall loan quality, along with a full-time workout specialist to manage collection and liquidation efforts.

Potential problem loans are defined as performing substandard loans which are not deemed to be impaired. These loans have characteristics that cause management to have doubts regarding the ability of the borrower to perform under present loan repayment terms and which may result in reporting these loans as non-performing loans in the future. Potential problem loans amounted to \$5,043,000 at December 31, 2017, \$5,556,000 at December 31, 2016 and \$2,280,000 at December 31, 2015.

Impaired loans were \$13,926,000 at December 31, 2017 and \$14,297,000 at December 31, 2016. The largest impaired loan relationship at December 31, 2017 consisted of one performing loan to a student housing holding company in the amount of \$3,112,000, which was secured by commercial real estate. The loan was downgraded to substandard status and modified as a TDR during the first quarter of 2015 due to the borrower's failure to achieve stabilization and meet projected occupancy rates that was attributed to the overall economic decline in students' disposable income and an increase in enrollment in online courses. The loan experienced a secondary modification during the third quarter of 2016 to extend the repayment term and modify the interest rate. The discounted cash flow evaluation at December 31, 2017 resulted in a specific allocation of \$0. The second largest impaired loan relationship at December 31, 2017 consisted of a non-performing participation loan to a student housing holding company which was secured by commercial real estate. The Corporation's share of the loan at December 31, 2017 was \$2,318,000. The loan was downgraded to substandard and placed on non-accrual status during the third quarter of 2015 due to the borrower's inability to reach a break-even rental income, related to the borrower's failure to meet projected occupancy rates. One participant's share in the amount of \$1,350,000 was repurchased during the third quarter of 2017. The collateral evaluation of the total participation at December 31, 2017 carried a value of \$2,942,000, after considering estimated appraisal adjustments and cost to sell of 21% and considering the total participation outstanding note balance, resulted in the Bank's specific allocation of \$303,000 for its share of



the participation. The third largest impaired loan relationship at December 31, 2017 consisted of a substandard performing loan to a developer of a residential sub-division in the amount of \$1,664,000, which was secured by commercial real estate. The contract was extended and the loan was modified as a TDR during the fourth quarter of 2015 because the weak real estate market has hindered the process of the development plans and expected sales of building lots have not materialized. The loan experienced a subsequent modification during the fourth quarter of 2017 to extend the maturity date to October 2020, reset the interest rate from a floating rate to a fixed rate, commence regular principal and interest payments and take additional real estate collateral. The discounted cash flow evaluation at December 31, 2017 resulted in a specific allocation of \$0.

The Bank estimates impairment based on its analysis of the cash flows or collateral estimated at fair value less cost to sell. For collateral dependent loans, the estimated appraisal adjustments and cost to sell percentages are determined based on the market area in which the real estate securing the loan is located, among other factors, and therefore, can differ from one loan to another. Of the \$13,926,000 in impaired loans at December 31, 2017, none were located outside the Corporation's primary market area.

The outstanding recorded investment of loans categorized as TDRs was \$9,109,000 as of December 31, 2017, compared to \$11,629,000 as of December 31, 2016 and \$11,096,000 as of December 31, 2015. The decrease in TDRs at December 31, 2017 as compared to December 31, 2016 is attributable to large payments and pay-downs made on existing TDRs net against smaller loans modified as TDRs during the year ended December 31, 2017. Of the thirty-three restructured loans at December 31, 2017, six loans are classified in the Commercial and Industrial portfolio, twenty-six loans are classified in the Commercial Real Estate portfolio, and one loan is classified in the Residential Real Estate portfolio. Troubled debt restructurings at December 31, 2017 consisted of seventeen term modifications beyond the original stated term, four interest rate modifications, and eleven payment modifications. At December 31, 2017, there was also one troubled debt restructuring that experienced all three types of modification – payment, rate, and term. TDRs are separately evaluated for impairment disclosures, and if necessary, a specific allocation is established. As of December 31, 2017 and 2015, there were \$2,000 and \$390,000, respectively, in specific allocations attributable to the TDRs and as of December 31, 2016, there were no specific allocations attributable to the TDRs. There were \$0, \$2,000, and \$31,000 in unused commitments on TDRs at December 31, 2017, 2016, and 2015, respectively.

At December 31, 2017, six Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$340,000 and one Residential Real Estate loan classified as a TDR with a recorded investment of \$60,000 were not in compliance with the terms of their restructure, compared to December 31, 2016 when ten Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$810,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of \$15,000 were not in compliance with the terms of their restructure and December 31, 2015 when two Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$249,000 were not in compliance with the terms of their restructure.

During the twelve months ended December 31, 2017, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same periods in 2016 and 2015 when one Commercial and Industrial loan in the amount of \$15,000 and one Commercial Real Estate loan in the amount of \$49,000, both modified as TDRs within the twelve months preceding December 31, 2016 and four Commercial Real Estate loans totaling \$4,382,000 that were modified as TDRs within the twelve months preceding December 31, 2015 has experienced payment defaults. The significant increase in defaulted TDRs at December 31, 2015 as compared to December 31, 2016 is largely due to one loan to a student housing holding company with a balance of \$4,204,000 at December 31, 2015, which was modified as a TDR during the first quarter of 2015 and experienced its subsequent default during the second quarter of 2015.

The Corporation's non-accrual loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values.

For non-accrual loans less than \$250,000 upon classification and typically at year end, the Corporation completes a Certificate of Inspection, which includes the results of an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations.

Improving loan quality is a priority. The Corporation actively works with borrowers to resolve credit problems and will continue its close monitoring efforts in 2018. Excluding the assets disclosed in Table 12 – Non-Performing Assets and Impaired Loans and the Troubled Debt Restructurings section in Note 4 — Loans and Allowance for Loan Losses, management is not aware of any information about borrowers' possible credit problems which cause serious doubt as to their ability to comply with present loan repayment terms.

Should the economic climate no longer continue to be stable or deteriorate further, borrowers may experience difficulty, and the level of impaired loans and non-performing assets, charge-offs and delinquencies could rise and possibly require additional increases in the Corporation's allowance for loan losses.

In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for possible loan losses. They may require additions to allowances based upon their judgments about information available to them at the time of examination.

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of December 31, 2017, 2016, and 2015 management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

**Table 12 — Non-Performing Assets and Impaired Loans**

(Dollars in thousands)

	December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
<b>Non-performing assets</b>			
Non-accrual loans	\$ 5,090	\$ 2,935	\$ 2,748
Foreclosed assets held for resale	1,071	1,273	1,472
Loans past-due 90 days or more and still accruing interest	70	34	166
Total non-performing assets	<u>\$ 6,231</u>	<u>\$ 4,242</u>	<u>\$ 4,386</u>
 Impaired loans			
Non-accrual loans	\$ 5,090	\$ 2,935	\$ 2,748
Accruing TDRs	8,836	11,362	10,619
Total impaired loans	13,926	14,297	13,367
Allocated allowance for loan losses	(327)	(219)	(340)
Net investment in impaired loans	<u>\$13,599</u>	<u>\$14,078</u>	<u>\$13,027</u>
 Impaired loans with a valuation allowance	\$ 2,646	\$ 1,392	\$ 4,640
Impaired loans without a valuation allowance	11,280	12,905	8,727
Total impaired loans	<u>\$13,926</u>	<u>\$14,297</u>	<u>\$13,367</u>
 Allocated valuation allowance as a percent of impaired loans	2.3%	1.5%	2.5%
Impaired loans to total loans	2.5%	2.7%	2.6%
Non-performing assets to total loans	1.1%	0.8%	0.8%
Non-performing assets to total assets	0.6%	0.4%	0.4%
Allowance for loan losses to impaired loans	53.8%	51.5%	50.4%
Allowance for loan losses to total non-performing assets	120.2%	173.5%	153.6%

Real estate mortgages comprise 81.1% of the loan portfolio as of December 31, 2017, as compared to 82.8% as of December 31, 2016. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely comprised of fixed rate mortgages. The real estate loans are concentrated primarily in the Corporation's market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately every three to five years and are also concentrated in the Corporation's market area. The Corporation's loss exposure on its impaired loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

## DEPOSITS AND OTHER BORROWED FUNDS

Consumer and commercial retail deposits are attracted primarily by the Bank's eighteen full service office locations and through its internet banking presence. The Bank offers a broad selection of deposit products and continually evaluates its interest rates and fees on deposit products. The Bank regularly reviews competing financial institutions interest rates, especially when establishing interest rates on certificates of deposit.

Deposits increased by \$52,164,000, or 7.2% for the year ending December 31, 2017 as compared to a deposit increase of \$5,384,000, or 0.7% as of December 31, 2016. The increase in deposits in 2017 can be attributed to increases in demand deposits, savings accounts and certificates of deposits. The increase in deposits in 2016 can be attributed to increases in demand deposits and savings accounts paired with a large increase in jumbo certificates of deposits due to purchases by a large municipal depositor.

The following schedule reflects the remaining maturities of time deposits and other time deposits of \$100,000 or more at December 31, 2017.

(Dollars in thousands)

	Time Deposits ≥\$100,000	Other Time Deposits ≥\$100,000
Less than or equal to 3 months	\$ 8,062	\$ —
Over 3 months through 6 months	5,431	855
Over 6 months through 12 months	22,402	—
Over 12 months	<u>56,213</u>	<u>—</u>
	<u>\$ 92,108</u>	<u>\$ 855</u>

Total borrowings were \$91,296,000 as of December 31, 2017, compared to \$144,406,000 on December 31, 2016. During 2017, long-term borrowings decreased from \$75,116,000 to \$65,000,000. The decrease in long-term borrowings in 2017 primarily resulted from the maturity of one individual term note with FHLB. In 2016, long-term borrowings increased from \$70,232,000 to \$75,116,000. The increase in long-term borrowings in 2016 occurred in order to sustain growth in the Bank's loan portfolio and to secure financing at low market rates. Long-term borrowings are typically FHLB term borrowings with a maturity of one year or more.

Short-term debt decreased from \$69,290,000 in 2016 to \$26,296,000 as of December 31, 2017 as a result of increased deposit balances. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window and short-term borrowings from FHLB. Short-term borrowings from FHLB are commonly used to offset seasonal fluctuations in deposits.

In connection with FHLB borrowings, Federal Discount Window, and securities sold under agreements to repurchase, the Corporation maintains certain eligible assets as collateral.

The following table shows information about the Corporation's short-term borrowings as of December 31, 2017 and 2016.

**Table 13 — Short-Term Borrowings**

(Dollars in thousands)

	<u>2017</u>			
	<u>Month End Balance</u>	<u>Average Balance</u>	<u>Maximum Month End Balance</u>	<u>Average Rate</u>
Federal funds purchased	\$ —	\$ —	\$ —	1.82%
Securities sold under agreements to repurchase	22,844	21,872	23,452	0.41%
Federal Discount Window	—	10	—	1.71%
Federal Home Loan Bank	<u>3,452</u>	<u>64,830</u>	<u>115,445</u>	<u>1.16%</u>
	<u>\$ 26,296</u>	<u>\$ 86,712</u>	<u>\$ 138,897</u>	<u>0.97%</u>

(Dollars in thousands)

	<u>2016</u>			
	<u>Month End Balance</u>	<u>Average Balance</u>	<u>Maximum Month End Balance</u>	<u>Average Rate</u>
Federal funds purchased	\$ —	\$ —	\$ —	1.10%
Securities sold under agreements to repurchase	18,490	22,218	24,302	0.26%
Federal Discount Window	—	—	—	1.10%
Federal Home Loan Bank	<u>50,800</u>	<u>44,192</u>	<u>83,682</u>	<u>0.59%</u>
	<u>\$ 69,290</u>	<u>\$ 66,410</u>	<u>\$ 107,984</u>	<u>0.48%</u>

## CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, the net unrealized gains or losses on investment securities available-for-sale, net of taxes, referred to as accumulated other comprehensive income (loss), may increase or decrease total equity capital. The total net increase in capital was \$7,034,000 in 2017 after an increase of \$1,247,000 in 2016. The increase in equity capital in 2017 was due to the retention of \$2,503,000 in earnings and the issuance of new shares through the Corporation's Dividend Reinvestment Program ("DRIP") amounting to \$1,261,000. Accumulated other comprehensive income (loss) increased \$3,245,000 in 2017 as a result of market fluctuations in the investment portfolio. The increase in equity capital in 2016 was due to the retention of \$3,382,000 in earnings and the issuance of new shares through the Corporation's Dividend Reinvestment Program ("DRIP") amounting to \$1,319,000.

The Corporation had 231,612 shares of common stock as of December 31, 2017 and 233,112 shares as of December 31, 2016, at a cost of \$5,709,000 and \$5,756,000, respectively as treasury stock, authorized and issued but not outstanding.

Return on average equity ("ROE") is computed by dividing net income by average stockholders' equity. This ratio was 7.54% for 2017, 8.23% for 2016, and 8.43% for 2015. Refer to Performance Ratios on page 23 — Selected Financial Data for a more expanded listing of the ROE.

Adequate capitalization of banks and bank holding companies is required and monitored by regulatory authorities. Table 14 reflects risk-based capital ratios and the leverage ratio for the Bank. The Bank's leverage ratio was 8.84% at December 31, 2017 and 8.67% at December 31, 2016.

The Bank has consistently maintained regulatory capital ratios at or above the "well capitalized" standards. To be categorized as "well capitalized", the Bank must maintain minimum tier 1 risk-based capital, common equity tier 1 risk based capital, total risk-based capital and tier 1 leverage ratios of 8.0%, 6.5%, 10.0% and 5.0%, respectively. For additional information on capital ratios, see Note 15 — Regulatory Matters. The risk-based capital calculation assigns various levels of risk to different categories of bank assets, requiring higher levels of capital for assets with more risk. Also measured in the risk-based capital ratio is credit risk exposure associated with off-balance sheet contracts and commitments.

### Table 14 — Capital Ratios

At December 31, 2017 the Bank met the definition of a "well-capitalized" institution under the regulatory framework for prompt corrective action and the minimum capital requirements under Basel III. The following table presents the Bank's capital ratios as of December 31, 2017 and December 31, 2016:

	<b>December 31, 2017</b>	December 31, 2016	To Be Well Capitalized Under Prompt Corrective Action Regulations
Tier 1 leverage ratio (to average assets)	<b>8.84%</b>	8.67%	5.00%
Common Equity Tier 1 capital ratio (to risk-weighted assets)	<b>13.06%</b>	13.06%	6.50%
Tier 1 risk-based capital ratio (to risk-weighted assets)	<b>13.06%</b>	13.06%	8.00%
Total risk-based capital ratio	<b>14.21%</b>	14.24%	10.00%

Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity tier 1 capital ratio to 7.0%, the tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of December 31, 2017, the Corporation would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

The Corporation's capital ratios are not materially different than those of the Bank.

## LIQUIDITY MANAGEMENT

The Corporation's objective is to maintain adequate liquidity to meet funding needs at a reasonable cost and provide contingency plans to meet unanticipated funding needs or a loss of funding sources, while minimizing interest rate risk. Adequate liquidity is needed to provide the funding requirements of depositors' withdrawals, loan growth, and other operational needs.

Sources of liquidity are as follows:

- Growth in the core deposit base;
- Proceeds from sales or maturities of investment securities;
- Payments received on loans and mortgage-backed securities;
- Overnight correspondent bank borrowings on various credit lines;
- Borrowing capacity available from correspondent banks: FHLB, Atlantic Community Bankers Bank ("ACBB"), and Federal Reserve Bank;
- Securities sold under agreements to repurchase; and
- Brokered CDs.

At December 31, 2017, the Corporation had \$299,115,000 in available borrowing capacity at FHLB (which takes into account FHLB long-term notes and FHLB short-term borrowings); the maximum borrowing capacity at ACBB was \$15,000,000 and the maximum borrowing capacity of the Federal Discount Window was \$5,374,000.

The Corporation enters into "Repurchase Agreements" in which it agrees to sell securities subject to an obligation to repurchase the same or similar securities. Because the agreement both entitles and obligates the Corporation to repurchase the assets, the Corporation may transfer legal control of the securities while still retaining effective control. As a result, the repurchase agreements are accounted for as collateralized financing agreements (secured borrowings) and act as an additional source of liquidity. Securities sold under agreements to repurchase were \$22,844,000 at December 31, 2017.

Asset liquidity is provided by investment securities maturing in one year or less, other short-term investments, federal funds sold, and cash and due from banks. The liquidity is augmented by repayment of loans and cash flows from mortgage-backed securities. Liability liquidity is accomplished by maintaining a core deposit base, acquired by attracting new deposits and retaining maturing deposits. Also, short-term borrowings provide funds to meet liquidity needs.

Net cash flows provided by operating activities were \$12,204,000, \$11,753,000, and \$10,285,000 at December 31, 2017, 2016, and 2015, respectively. Net income amounted to \$8,648,000 for the year ended December 31, 2017, \$9,472,000 for the year ended December 31, 2016, and \$9,172,000 for the year ended December 31, 2015. During the years ended December 31, 2017, 2016, and 2015, net premium amortization on investment securities amounted to \$4,546,000, \$4,012,000, and \$2,930,000, respectively. Net cash utilized for originations of mortgage loans originated for resale exceeded proceeds (including gains) from sales of mortgage loans originated for resale by \$422,000 and \$2,769,000 for the years ended December 31, 2017 and 2016, respectively. During the year ended December 31, 2015, proceeds (including gains) from sales of mortgage loans originated for resale exceeded net cash utilized for originations of mortgage loans originated for resale by \$1,540,000. Other assets decreased \$203,000 and \$233,000 during the years ended December 31, 2017 and 2016, respectively, and increased \$1,191,000 during the year ended December 31, 2015. Other liabilities decreased \$313,000 and \$2,148,000 during the years ended December 31, 2017 and 2015, respectively, and increased \$477,000 during the year ended December 31, 2016.

Investing activities used \$6,788,000, \$5,881,000, and \$75,843,000 during the years ended December 31, 2017, 2016, and 2015, respectively. Net activity in the available-for-sale securities portfolio (including proceeds from sale, maturities, and redemptions net against purchases) provided cash of \$30,734,000 during the year ended December 31, 2017 and used cash of \$1,876,000 and \$41,869,000 during the years ended December 31, 2016 and 2015, respectively. Net cash used to originate loans amounted to \$36,506,000, \$4,245,000, and \$34,397,000 during the years ended December 31, 2017, 2016, and 2015, respectively.

Financing activities used cash of \$5,805,000 and \$5,752,000 during the years ended December 31, 2017 and 2016, respectively, and provided cash of \$66,599,000 during the year ended December 31, 2015. During the years ended December 31, 2017, 2016, and 2015, deposits increased by \$52,164,000, \$5,384,000, and \$59,036,000, respectively. Short-term borrowings decreased by \$42,994,000 and \$11,249,000 during the years ended December 31, 2017 and 2016, respectively, and increased by \$7,416,000 during the year ended December 31, 2015. Repayment of long-term borrowings used cash of \$10,116,000 during the year ended December 31, 2017 and proceeds from long-term borrowings exceeded repayment of long-term borrowings by \$4,884,000 and \$4,893,000 during the years ended December 31, 2016 and 2015, respectively. Dividends paid amounted to \$6,145,000, \$6,090,000, and \$6,035,000 during the years ended December 31, 2017, 2016, and 2015, respectively.

Managing liquidity remains an important segment of asset/liability management. The overall liquidity position of the Corporation is maintained by an active asset/liability management committee. The Corporation believes that its core deposit base is stable even in periods of changing interest rates. Liquidity and funds management are governed by policies and measured on a monthly basis. These measurements indicate that liquidity generally remains stable and exceeds the Corporation's minimum defined levels of adequacy. Other than the trends of continued competitive pressures and volatile interest rates, there are no known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, liquidity increasing or decreasing in any material way.

Table 15 represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of December 31, 2017.

**Table 15 — Contractual Obligations**

*(Dollars in thousands)*

<b>December 31, 2017</b>	Less than 1 Year	1 - 3 Years	4 -5 Years	Over 5 Years	Total
Time deposits	\$ 82,892	\$ 88,447	\$ 33,894	\$ 2,395	\$ 207,628
Securities sold under agreement to repurchase	22,844	—	—	—	22,844
Short-term borrowings	3,452	—	—	—	3,452
Long-term borrowings	23,000	30,000	10,000	2,000	65,000
Operating lease obligations	134	169	127	2,462	2,892
	<u>\$ 132,322</u>	<u>\$ 118,616</u>	<u>\$ 44,021</u>	<u>\$ 6,857</u>	<u>\$ 301,816</u>

### ***Off-Balance Sheet Arrangements***

The Corporation is 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 include commitments to extend credit and, to a lesser extent, standby letters of credit. At December 31, 2017, the Corporation had unfunded outstanding commitments to extend credit of \$90,373,000 and outstanding standby letters of credit of \$3,351,000. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. Please refer to Note 16 — Financial Instruments with Off-Balance Sheet Risk and Concentrations of Credit Risk for a discussion of the nature, business purpose, and importance of the Corporation's off-balance sheet arrangements.

### **MARKET RISK**

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. The Corporation's market risk is composed primarily of interest rate risk. The Corporation's interest rate risk results from timing differences in the repricing of assets, liabilities, off-balance sheet instruments, and changes in relationships between rate indices and the potential exercise of explicit or embedded options.

Increases in the level of interest rates also may adversely affect the fair value of the Corporation's securities and other earning assets. Generally, the fair value of fixed-rate instruments fluctuates inversely with changes in interest rates. As a result, increases in interest rates could result in decreases in the fair value of the Corporation's interest-earning assets, which could adversely affect the Corporation's results of operations if sold, or, in the case of interest-earning assets classified as available-for-sale, the Corporation's stockholders' equity, if retained. Under FASB ASC 320-10, *Investment Debt and Equity Securities*, changes in the unrealized gains and losses, net of taxes, on securities classified as available-for-sale are reflected in the Corporation's stockholders' equity. The Corporation does not own any trading assets.

## Asset/Liability Management

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Table 16 presents an interest sensitivity analysis of assets and liabilities as of December 31, 2017. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in Table 16 include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation's position on a single day (December 31, 2017 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive.

**Table 16 — Interest Rate Sensitivity Analysis**

*(Dollars in thousands)*

	December 31, 2017				
	One Year	1 - 5 Years	Beyond 5 Years	Not Rate Sensitive	Total
Assets	\$ 140,145	\$ 363,055	\$ 432,019	\$ 54,902	\$ 990,121
Liabilities/Stockholders' Equity	<u>253,214</u>	<u>258,026</u>	<u>364,893</u>	<u>113,988</u>	990,121
Interest Rate Sensitivity Gap	\$(113,069)	\$ 105,029	\$ 67,126	\$(59,086)	
Cumulative Gap	\$(113,069)	\$ (8,040)	\$ 59,086	—	

## Earnings at Risk

The Bank's Asset/Liability Committee ("ALCO") is responsible for reviewing the interest rate sensitivity position and establishing policies to monitor and limit exposure to interest rate risk. The guidelines established by ALCO are reviewed by the Corporation's Board of Directors. The Corporation recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet beyond interest rate sensitivity gap. Although the Corporation continues to measure its interest rate sensitivity gap, the Corporation utilizes additional modeling for interest rate risk in the overall balance sheet. Earnings at risk and economic values at risk are analyzed.

Earnings simulation modeling addresses earnings at risk and net present value estimation addresses economic value at risk. While each of these interest rate risk measurements has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk to the Corporation.

## Earnings Simulation Modeling

The Corporation's net income is affected by changes in the level of interest rates. Net income is also subject to changes in the shape of the yield curve. For example, a flattening of the yield curve would result in a decline in earnings due to the compression of earning asset yields and increased liability rates, while a steepening would result in increased earnings as earning asset yields widen.

Earnings simulation modeling is the primary mechanism used in assessing the impact of changes in interest rates on net interest income. The model reflects management's assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, size and composition of the balance sheet. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Earnings at risk is the change in net interest income from a base case scenario under various scenarios of rate shock increases and decreases in the interest rate earnings simulation model.

Table 17 presents an analysis of the changes in net interest income and net present value of the balance sheet resulting from various increases or decreases in the level of interest rates, such as two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net interest income would decrease 8.0%, 15.2% and 21.3% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would increase 3.0% and 0.0% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines.

The analysis and model used to quantify the sensitivity of net interest income becomes less reliable in a decreasing rate scenario given the current unprecedented low interest rate environment with federal funds trading in the 100 – 150 basis point range. Results of the decreasing basis point declining scenarios are affected by the fact that many of the Corporation's interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or more basis points. However, the Corporation's interest-sensitive assets are able to decline by these amounts. For the years ended December 31, 2017 and 2016, the cost of interest-bearing liabilities averaged 0.86% and 0.71%, respectively, and the yield on average interest-earning assets, on a fully taxable equivalent basis, averaged 3.79% and 3.74%, respectively.

### ***Net Present Value Estimation***

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At December 31, 2017, the 100 and 200 basis point immediate decreases in rates are estimated to affect net present value with a decrease of 7.0% and 28.0%, respectively. Additionally, net present value is projected to decrease 1.0%, 6.0%, and 13.0% in the 100, 200 and 300 basis point immediate increase scenarios, respectively. All scenarios presented are within the Corporation's policy limits.

The computation of the effects of hypothetical interest rate changes are based on many assumptions. They should not be relied upon solely as being indicative of actual results, since the computations do not contemplate actions management could undertake in response to changes in interest rates.

**Table 17 — Effect of Change in Interest Rates**

	<u>Projected Change</u>
<b>Effect on Net Interest Income</b>	
1-Year Net Income Simulation Projection	
+300 bp Shock vs. Stable Rate	(21.3)%
+200 bp Shock vs. Stable Rate	(15.2)%
+100 bp Shock vs. Stable Rate	(8.0)%
Flat rate	
-100 bp Shock vs. Stable Rate	3.0%
-200 bp Shock vs. Stable Rate	0.0%
<b>Effect on Net Present Value of Balance Sheet</b>	
Static Net Present Value Change	
+300 bp Shock vs. Stable Rate	(13.0)%
+200 bp Shock vs. Stable Rate	(6.0)%
+100 bp Shock vs. Stable Rate	(1.0)%
Flat rate	
-100 bp Shock vs. Stable Rate	(7.0)%
-200 bp Shock vs. Stable Rate	(28.0)%



Table 18 shows the quarterly results of operations for the Corporation for the years ended December 31, 2017 and 2016:

**Table 18 — Quarterly Results of Operations (Unaudited)**

*(Dollars in thousands, except per share data)*

	<b>Three Months Ended</b>			
	<b>March 31</b>	<b>June 30</b>	<b>September 30</b>	<b>December 31</b>
<b>2017</b>				
Interest income	<u>\$ 7,897</u>	<u>\$ 8,010</u>	<u>\$ 8,164</u>	<u>\$ 8,197</u>
Interest expense	<u>1,419</u>	<u>1,627</u>	<u>1,787</u>	<u>1,715</u>
Net interest income	<u>6,478</u>	<u>6,383</u>	<u>6,377</u>	<u>6,482</u>
Provision for loan losses	<u>83</u>	<u>—</u>	<u>84</u>	<u>100</u>
Non-interest income	<u>1,538</u>	<u>1,495</u>	<u>1,713</u>	<u>1,425</u>
Non-interest expense	<u>5,263</u>	<u>5,666</u>	<u>5,681</u>	<u>4,911</u>
Income before income tax expense	<u>2,670</u>	<u>2,212</u>	<u>2,325</u>	<u>2,896</u>
Income tax expense	<u>384</u>	<u>293</u>	<u>269</u>	<u>509</u>
Net income	<u><u>\$ 2,286</u></u>	<u><u>\$ 1,919</u></u>	<u><u>\$ 2,056</u></u>	<u><u>\$ 2,387</u></u>
Basic and diluted earnings per share	<u>\$ 0.40</u>	<u>\$ 0.34</u>	<u>\$ 0.36</u>	<u>\$ 0.42</u>

*(Dollars in thousands, except per share data)*

	<b>Three Months Ended</b>			
	<b>March 31</b>	<b>June 30</b>	<b>September 30</b>	<b>December 31</b>
<b>2016</b>				
Interest income	<u>\$ 7,969</u>	<u>\$ 7,932</u>	<u>\$ 7,926</u>	<u>\$ 7,816</u>
Interest expense	<u>1,310</u>	<u>1,285</u>	<u>1,309</u>	<u>1,378</u>
Net interest income	<u>6,659</u>	<u>6,647</u>	<u>6,617</u>	<u>6,438</u>
Provision for loan losses	<u>283</u>	<u>284</u>	<u>1,133</u>	<u>383</u>
Non-interest income	<u>1,300</u>	<u>1,666</u>	<u>2,158</u>	<u>2,263</u>
Non-interest expense	<u>5,140</u>	<u>5,014</u>	<u>5,078</u>	<u>5,116</u>
Income before income tax expense	<u>2,536</u>	<u>3,015</u>	<u>2,564</u>	<u>3,202</u>
Income tax expense	<u>360</u>	<u>524</u>	<u>420</u>	<u>541</u>
Net income	<u><u>\$ 2,176</u></u>	<u><u>\$ 2,491</u></u>	<u><u>\$ 2,144</u></u>	<u><u>\$ 2,661</u></u>
Basic and diluted earnings per share	<u>\$ 0.39</u>	<u>\$ 0.44</u>	<u>\$ 0.38</u>	<u>\$ 0.47</u>

### **Critical Accounting Estimates**

The Corporation has chosen accounting policies that it believes are appropriate to accurately and fairly report its operating results and financial position, and the Corporation has applied those policies in a consistent manner.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require that the Corporation make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates and assumptions are based on historical or other factors believed to be reasonable under the circumstances. The Corporation evaluates these estimates and assumptions on an ongoing basis and may retain outside consultants, lawyers and actuaries to assist in its evaluation. These estimates, assumptions and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated financial statements could reflect different estimates, assumptions and judgments.

The Corporation considers two accounting policies to be critical because they involve the most significant judgments and estimates used in preparation of its consolidated financial statements. The two policies are the determination of other-than-temporary impairment of securities and the determination of the allowance for loan losses.

**Other-Than-Temporary Impairment of Securities.** Valuations for the investment portfolio are determined using quoted market prices, where available. If quoted market prices are not available, investment valuation is based on pricing models, quotes for similar investment securities, and observable yield curves and spreads. In addition to valuation, management must assess whether there are any declines in value below the carrying value of the investments that should be considered other than temporary or otherwise require an adjustment in carrying value and recognition of the loss in the Corporation's Consolidated Statements of Income.

***Allowance for Loan Losses.*** The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the Corporation's Consolidated Balance Sheets.

#### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Information with respect to quantitative and qualitative disclosures about market risk is included in the information under Management's Discussion and Analysis in Item 7 hereof.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders  
First Keystone Corporation  
Berwick, Pennsylvania

**Opinion of the Consolidated Financial Statements**

We have audited the accompanying consolidated balance sheets of First Keystone Corporation and Subsidiary (the “Corporation”) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for each of the three years in the period ending December 31, 2017, and related notes (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Corporation at December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Corporation Accounting Oversight Board (United States) (“PCAOB”), the Corporation’s internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and our report dated March 16, 2018 expressed an unqualified opinion thereon.

**Basis for Opinion**

These consolidated financial statements are the responsibility of the Corporation’s management. Our responsibility is to express an opinion on the Corporation’s consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Corporation in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Corporation’s auditor since 2014.

Harrisburg, Pennsylvania  
March 16, 2018

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands, except per share data)

	December 31,	
	2017	2016
<b>ASSETS</b>		
Cash and due from banks	\$ 7,913	\$ 8,338
Interest-bearing deposits in other banks	<u>826</u>	<u>790</u>
Total cash and cash equivalents	8,739	9,128
Time deposits with other banks	1,482	1,482
Investment securities available-for-sale	350,218	379,637
Investment securities held-to-maturity (fair value 2017 - \$0; 2016 - \$4)	—	4
Restricted investment in bank stocks	4,058	5,477
Loans	559,397	522,382
Allowance for loan losses	<u>(7,487)</u>	<u>(7,357)</u>
Net loans	551,910	515,025
Premises and equipment, net	20,623	19,237
Accrued interest receivable	4,237	3,917
Cash surrender value of bank owned life insurance	22,354	21,718
Investments in low-income housing partnerships	2,626	2,555
Goodwill	19,133	19,133
Foreclosed assets held for resale	1,071	1,273
Deferred income taxes	936	2,760
Other assets	<u>2,734</u>	<u>2,937</u>
<b>TOTAL ASSETS</b>	<b><u>\$ 990,121</u></b>	<b><u>\$ 984,283</u></b>
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$ 121,415	\$ 110,314
Interest bearing	<u>656,731</u>	<u>615,668</u>
Total deposits	778,146	725,982
Short-term borrowings	26,296	69,290
Long-term borrowings	65,000	75,116
Accrued interest payable	490	427
Other liabilities	<u>3,470</u>	<u>3,783</u>
<b>TOTAL LIABILITIES</b>	<b><u>873,402</u></b>	<b><u>874,598</u></b>
<b>STOCKHOLDERS' EQUITY</b>		
Preferred stock, par value \$2.00 per share; authorized 1,000,000 shares as of December 31, 2017 and 2016; issued 0 in 2017 and 2016	—	—
Common stock, par value \$2.00 per share; authorized 20,000,000 shares as of December 31, 2017 and 2016; issued 5,950,951 as of December 31, 2017 and 5,904,563 as of December 31, 2016; outstanding 5,719,339 as of December 31, 2017 and 5,671,451 as of December 31, 2016	11,902	11,809
Surplus	36,193	35,047
Retained earnings	72,507	70,004
Accumulated other comprehensive income (loss)	1,826	(1,419)
Treasury stock, at cost, 231,612 shares in 2017 and 233,112 shares in 2016	<u>(5,709)</u>	<u>(5,756)</u>
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b><u>116,719</u></b>	<b><u>109,685</u></b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b><u>\$ 990,121</u></b>	<b><u>\$ 984,283</u></b>

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

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands, except per share data)

	Years Ended December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
<b>INTEREST INCOME</b>			
Interest and fees on loans	<b>\$ 22,615</b>	\$ 21,952	\$ 21,607
Interest and dividend income on investment securities:			
Taxable	4,304	5,507	6,464
Tax-exempt	4,979	3,829	3,131
Dividends	47	65	62
Dividend income on restricted investment in bank stocks	289	253	415
Interest on interest-bearing deposits in other banks	34	37	32
<b>Total interest income</b>	<b><u>32,268</u></b>	<b><u>31,643</u></b>	<b><u>31,711</u></b>
<b>INTEREST EXPENSE</b>			
Interest on deposits	4,232	3,425	3,159
Interest on short-term borrowings	844	318	264
Interest on long-term borrowings	1,472	1,539	1,543
<b>Total interest expense</b>	<b><u>6,548</u></b>	<b><u>5,282</u></b>	<b><u>4,966</u></b>
Net interest income	25,720	26,361	26,745
Provision for loan losses	267	2,083	2,277
<b>Net interest income after provision for loan losses</b>	<b><u>25,453</u></b>	<b><u>24,278</u></b>	<b><u>24,468</u></b>
<b>NON-INTEREST INCOME</b>			
Trust department	880	840	877
Service charges and fees	1,803	1,786	1,773
Bank owned life insurance income	636	651	664
ATM fees and debit card income	1,396	1,304	1,224
Gains on sales of mortgage loans	316	358	548
Net investment securities gains	938	1,764	2,131
Impairment charges on equity securities	—	—	(14)
Gains from life insurance proceeds	—	458	—
Other	202	226	494
<b>Total non-interest income</b>	<b><u>6,171</u></b>	<b><u>7,387</u></b>	<b><u>7,697</u></b>
<b>NON-INTEREST EXPENSE</b>			
Salaries and employee benefits	11,170	10,484	11,012
Occupancy, net	1,777	1,747	1,813
Furniture and equipment	569	555	602
Computer expense	1,025	977	845
Professional services	866	657	609
Pennsylvania shares tax	742	700	712
FDIC insurance	321	482	532
ATM and debit card fees	697	651	600
Data processing fees	600	557	571
Foreclosed assets held for resale expense	135	289	111
Advertising	530	390	476
Other	3,089	2,859	3,139
<b>Total non-interest expense</b>	<b><u>21,521</u></b>	<b><u>20,348</u></b>	<b><u>21,022</u></b>
<b>Income before income tax expense</b>	<b>10,103</b>	11,317	11,143
<b>Income tax expense</b>	<b><u>1,455</u></b>	<u>1,845</u>	<u>1,971</u>
<b>NET INCOME</b>	<b><u>\$ 8,648</u></b>	<b><u>\$ 9,472</u></b>	<b><u>\$ 9,172</u></b>
<b>PER SHARE DATA</b>			
Net income per share:			
Basic	\$ 1.52	\$ 1.68	\$ 1.64
Diluted	1.52	1.68	1.64
Dividends per share	1.08	1.08	1.08

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

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

*(Dollars in thousands)*

	Years Ended December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
Net Income	\$ 8,648	\$ 9,472	\$ 9,172
Other comprehensive income (loss):			
Unrealized net holding gains (losses) on available-for-sale investment securities arising during the period, net of income taxes of \$2,002, \$(1,154) and \$(466), respectively	3,859	(2,314)	(898)
Less reclassification adjustment for net gains included in net income, net of income taxes of \$(324), \$(624) and \$(725), respectively (a) (c)	(614)	(1,140)	(1,406)
Less reclassification adjustment for impairment charges on equity securities included in net income, net of income taxes of \$0, \$0 and \$5, respectively (b) (c)	<u>—</u>	<u>—</u>	<u>9</u>
Total other comprehensive income (loss)	<u>3,245</u>	<u>(3,454)</u>	<u>(2,295)</u>
Total Comprehensive Income	<u>\$ 11,893</u>	<u>\$ 6,018</u>	<u>\$ 6,877</u>

(a) Gross amounts are included in net investment securities gains on the Consolidated Statements of Income in non-interest income.

(b) Gross amounts are included in impairment charges on equity securities on the Consolidated Statements of Income in non-interest income.

(c) Income tax amounts are included in income tax expense on the Consolidated Statements of Income.

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

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**Years Ended December 31, 2017, 2016 and 2015**

*(Dollars in thousands, except per share data)*

	<u>Common Stock</u>		<u>Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive (Loss) Income</u>	<u>Treasury Stock</u>	<u>Total Stockholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>					
Balance at January 1, 2015	5,802,521	11,605	32,674	63,485	4,330	(5,823)	106,271
Net Income				9,172			9,172
Other comprehensive loss, net of taxes					(2,295)		(2,295)
Issuance of common stock under dividend reinvestment plan and exercise of employee stock options	50,796	102	1,156			67	1,325
Dividends - \$1.08 per share				(6,035)			(6,035)
Balance at December 31, 2015	<u>5,853,317</u>	<u>11,707</u>	<u>33,830</u>	<u>66,622</u>	<u>2,035</u>	<u>(5,756)</u>	<u>108,438</u>
Net Income				9,472			9,472
Other comprehensive loss, net of taxes					(3,454)		(3,454)
Issuance of common stock under dividend reinvestment plan	51,246	102	1,217				1,319
Dividends - \$1.08 per share				(6,090)			(6,090)
Balance at December 31, 2016	<u>5,904,563</u>	<u>11,809</u>	<u>35,047</u>	<u>70,004</u>	<u>(1,419)</u>	<u>(5,756)</u>	<u>109,685</u>
Net Income				<b>8,648</b>			<b>8,648</b>
Other comprehensive income, net of taxes					<b>3,245</b>		<b>3,245</b>
Issuance of common stock under dividend reinvestment plan and exercise of employee stock options	<b>46,388</b>	<b>93</b>	<b>1,146</b>			<b>47</b>	<b>1,286</b>
Dividends - \$1.08 per share				<b>(6,145)</b>			<b>(6,145)</b>
Balance at December 31, 2017	<u><b>5,950,951</b></u>	<u><b>\$ 11,902</b></u>	<u><b>\$ 36,193</b></u>	<u><b>\$ 72,507</b></u>	<u><b>\$ 1,826</b></u>	<u><b>\$ (5,709)</b></u>	<u><b>\$116,719</b></u>

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

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

OPERATING ACTIVITIES	Years Ended December 31,		
	2017	2016	2015
Net income	\$ 8,648	\$ 9,472	\$ 9,172
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	267	2,083	2,277
Depreciation and amortization	1,112	1,179	1,309
Net premium amortization on investment securities	4,546	4,012	2,930
Deferred income tax expense (benefit)	146	(290)	283
Gains on sales of mortgage loans	(316)	(358)	(515)
Gains on sales of mortgage loans held for investment transferred to held for sale	—	—	(33)
Proceeds from sales of mortgage loans originated for resale	11,484	10,159	19,791
Originations of mortgage loans originated for resale	(11,906)	(12,928)	(18,251)
Gains on sales of investment securities	(938)	(1,764)	(2,131)
Impairment charges on equity securities	—	—	14
Net (gains) losses on sales of foreclosed real estate held for resale, including write-downs	(19)	196	34
(Increase) decrease in accrued interest receivable	(320)	169	(773)
Earnings on investment in bank owned life insurance	(636)	(651)	(664)
Gains from bank-owned life insurance proceeds	—	(458)	—
Losses on disposals of premises and equipment	2	1	31
Decrease (increase) in other assets	203	233	(1,191)
Amortization of investment in real estate ventures	181	176	167
Increase (decrease) in accrued interest payable	63	45	(17)
(Decrease) increase in other liabilities	(313)	477	(2,148)
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>12,204</u>	<u>11,753</u>	<u>10,285</u>
<b>INVESTING ACTIVITIES</b>			
Proceeds from sales of investment securities available-for-sale	81,807	76,759	111,799
Proceeds from maturities and redemptions of investment securities available-for-sale	21,662	21,449	21,759
Purchases of investment securities available-for-sale	(72,735)	(100,084)	(175,427)
Proceeds from maturities and redemptions of investment securities held-to-maturity	4	22	1,030
Net change in restricted investment in bank stocks	1,419	265	(434)
Net increase in loans	(36,506)	(4,245)	(34,397)
Proceeds from sales of mortgage loans held for investment transferred to held for sale	—	—	940
Proceeds from bank-owned life insurance	—	1,291	—
Purchase of premises and equipment	(2,585)	(383)	(544)
Purchase of investment in real estate ventures	(252)	(1,178)	(590)
Proceeds from sales of foreclosed assets held for resale	398	223	21
NET CASH USED IN INVESTING ACTIVITIES	<u>(6,788)</u>	<u>(5,881)</u>	<u>(75,843)</u>
<b>FINANCING ACTIVITIES</b>			
Net increase in deposits	52,164	5,384	59,036
Net (decrease) increase in short-term borrowings	(42,994)	(11,249)	7,416
Proceeds from long-term borrowings	—	10,000	5,000
Repayment of long-term borrowings	(10,116)	(5,116)	(107)
Common stock issued	1,261	1,319	1,252
Proceeds from exercise of stock options	25	—	37
Dividends paid	(6,145)	(6,090)	(6,035)
NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES	<u>(5,805)</u>	<u>(5,752)</u>	<u>66,599</u>
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(389)	120	1,041
CASH AND CASH EQUIVALENTS, BEGINNING	9,128	9,008	7,967
CASH AND CASH EQUIVALENTS, ENDING	<u>\$ 8,739</u>	<u>\$ 9,128</u>	<u>\$ 9,008</u>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>			
Interest paid	\$ 6,485	\$ 5,237	\$ 4,983
Income taxes paid	1,292	634	2,631
<b>SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES</b>			
Loans transferred to foreclosed assets held for resale	177	220	1,472
Loans transferred (from) to held for sale portfolio	—	(4,881)	730
Common stock subscription receivable	—	—	36

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



**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**Notes to Consolidated Financial Statements**

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**NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The accounting policies of First Keystone Corporation and Subsidiary (the “Corporation”) are in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and conform to common practices within the banking industry. The more significant accounting policies follow:

**Principles of Consolidation**

The consolidated financial statements include the accounts of First Keystone Corporation and its wholly-owned subsidiary, First Keystone Community Bank (the “Bank”). All significant inter-company balances and transactions have been eliminated in consolidation.

**Nature of Operations**

The Corporation, headquartered in Berwick, Pennsylvania, provides a full range of banking, trust and related services through its wholly-owned Bank subsidiary and is subject to competition from other financial institutions in connection with these services. The Bank serves a customer base which includes individuals, businesses, governments, and public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has 18 full service offices and 20 Automated Teller Machines (“ATM”) located in Columbia, Luzerne, Montour and Monroe counties. The Corporation and its subsidiary must also adhere to certain federal and state banking laws and regulations and are subject to periodic examinations made by various state and federal agencies.

**Segment Reporting**

The Corporation’s subsidiary acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business, government, and public and institutional customers. Through its branch and ATM network, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. The Bank also performs personal, corporate, pension and fiduciary services through its Trust Department.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and mortgage banking operations of the Corporation. As such, discrete financial information is not available and segment reporting would not be meaningful.

**Significant Concentrations of Credit Risk**

The majority of the Corporation’s activities involve customers located primarily in Columbia, Luzerne, Montour and Monroe counties in Pennsylvania. The types of securities in which the Corporation invests are presented in Note 3 – Investment Securities. Credit risk as it relates to investment activities is moderated through the monitoring of ratings and geographic concentrations residing in the portfolio and the observance of minimum rating levels in the investment policy. Note 4 – Loans and Allowance for Loan Losses summarizes the types of lending in which the Corporation engages. The inherent risks associated with lending activities are mitigated by adhering to conservative underwriting practices and policies, as well as portfolio diversification and thorough monitoring of the loan portfolio. It is management’s opinion that the investment and loan portfolios were well balanced at December 31, 2017, to the extent necessary to avoid any significant concentrations of credit risk.

**Use of Estimates**

The preparation of these consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of these consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

## **FIRST KEYSTONE CORPORATION AND SUBSIDIARY**

### **Notes to Consolidated Financial Statements**

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Material estimates that are particularly susceptible to significant changes include the determination of other-than-temporary impairment on securities and the determination of the allowance for loan losses.

#### **Subsequent Events**

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of December 31, 2017, for items that should potentially be recognized or disclosed in the consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

#### **Cash and Cash Equivalents**

For purposes of reporting consolidated cash flows, cash and cash equivalents include cash on hand and due from banks, interest-bearing deposits in other banks, and federal funds sold. The Corporation considers cash classified as interest-bearing deposits with other banks as a cash equivalent since they are represented by cash accounts essentially on a demand basis and mature within one year. Federal funds are also included as a cash equivalent because they are generally purchased and sold for one-day periods.

#### **Time Deposits with Other Banks**

Time deposits with other banks consist of fully insured certificates of deposit in other banks with maturity dates between one and five years.

#### **Investment Securities**

The Corporation classifies its investment securities as either “Held-to-Maturity” or “Available-for-Sale” at the time of purchase. Investment securities are accounted for on a trade date basis. Debt securities are classified as Held-to-Maturity when the Corporation has the ability and positive intent to hold the securities to maturity. Investment securities classified as Held-to-Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

Debt securities not classified as Held-to-Maturity and equity securities are included in the Available-for-Sale category and are carried at fair value. The amount of any unrealized gain or loss, net of the effect of deferred income taxes, is reported as accumulated other comprehensive income (loss) in the Consolidated Balance Sheets and Consolidated Statements of Changes in Stockholders’ Equity. Management’s decision to sell Available-for-Sale securities is based on changes in economic conditions controlling the sources and applications of funds, terms, availability of and yield of alternative investments, interest rate risk and the need for liquidity.

The cost of debt securities classified as Held-to-Maturity or Available-for-Sale is adjusted for amortization of premiums and accretion of discounts to expected maturity. Such amortization and accretion, as well as interest and dividends, are included in interest and dividend income on investment securities. Realized gains and losses are included in net investment securities gains and losses. The cost of investment securities sold, redeemed or matured is based on the specific identification method.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320, *Investments - Debt and Equity Securities*. In determining OTTI under the FASB ASC 320 model, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**Notes to Consolidated Financial Statements**

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When other-than-temporary impairment occurs on debt securities, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is determined based on the present value of cash flows expected to be collected, and the realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment related to the other factors shall be recognized in other comprehensive income (loss), net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment.

The fair market value of the equity securities tends to fluctuate with the overall equity markets as well as the trends specific to each institution. The equity securities portfolio is reviewed in a similar manner as that of the debt securities with greater emphasis placed on the length of time the market value has been less than the carrying value and the financial sector outlook. The Corporation also reviews dividend payment activities, levels of non-performing assets and loan loss reserves. The starting point for the equity analysis is the length and severity of market value decline. The realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment is recognized in other comprehensive income (loss), net of applicable taxes. The previous cost basis less the other-than-temporary impairment recognized in earnings becomes the new cost basis of the investment.

**Restricted Investment in Bank Stocks**

The Bank owns restricted stock investments in the Federal Home Loan Bank of Pittsburgh ("FHLB-Pittsburgh") and Atlantic Community Bankers Bank ("ACBB"). These investments do not have a readily determinable fair value because their ownership is restricted and they can be sold back only to the FHLB-Pittsburgh, ACBB or to another member institution. Therefore, these investments are carried at cost. At December 31, 2017, the Corporation held \$4,023,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB. At December 31, 2016, the Corporation held \$5,442,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB.

Management evaluates the restricted investment in bank stocks for impairment on an annual basis. Management's determination of whether these investments are impaired is based on management's assessment of the ultimate recoverability of the cost of these investments rather than by recognizing temporary declines in value. The following factors were evaluated to determine the ultimate recoverability of the cost of the Corporation's restricted investment in bank stocks; (i) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted; (ii) commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank; (iii) the impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the correspondent bank; and (iv) the liquidity position of the correspondent bank. Based on the analysis of these factors, management determined that no impairment charge was necessary related to the restricted investment in bank stocks during 2017, 2016 or 2015.

**Loans**

Net loans are stated at their outstanding recorded investment, net of deferred fees and costs, unearned income and the allowance for loan losses. Interest on loans is recognized as income over the term of each loan, generally, by the accrual method. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the straight line method or the interest method over the contractual life of the related loans as an interest yield adjustment.

Residential mortgage loans held for sale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse. Loans held for sale amounted to \$834,000 at December 31, 2017 and \$100,000 at December 31, 2016.

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### **Notes to Consolidated Financial Statements**

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The loans receivable portfolio is segmented into commercial, residential and consumer loans. Commercial loans consist of the following classes: Commercial and Industrial and Commercial Real Estate.

#### *Commercial and Industrial Lending*

The Corporation originates commercial and industrial loans primarily to businesses located in its primary market area and surrounding areas. These loans are used for various business purposes, which include short-term loans and lines of credit to finance machinery and equipment, inventory and accounts receivable. Generally, the maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Most business lines of credit are written on demand and are reviewed annually.

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum thresholds have been established by the Corporation and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, business financial statements, collateral appraisals, etc. Commercial and industrial loans are typically secured by personal guarantees of the borrower.

In underwriting commercial and industrial loans, an analysis is performed to evaluate the borrower's character and capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as the conditions affecting the borrower. Evaluation of the borrower's past, present and future cash flows is also an important aspect of the Corporation's analysis of the borrower's ability to repay.

Commercial and industrial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions. Commercial and industrial loans are typically made on the basis of the borrower's ability to make repayment from cash flows from the borrower's primary business activities. As a result, the availability of funds for the repayment of commercial and industrial loans is dependent on the success of the business itself, which in turn, is likely to be dependent upon the general economic environment.

#### *Commercial Real Estate Lending*

The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation's commercial real estate portfolio is secured primarily by commercial retail space, commercial office buildings, residential housing and hotels. Generally, commercial real estate loans have terms that do not exceed twenty years, have loan-to-value ratios of up to eighty percent of the value of the collateral property, and are typically secured by personal guarantees of the borrowers.

In underwriting these loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. The value of the property is determined by either independent appraisers or internal evaluations by Bank officers.

Commercial real estate loans generally present a higher level of risk than residential real estate secured loans. Repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project and/or the effect of the general economic conditions on income producing properties.

#### *Residential Real Estate Lending (Including Home Equity)*

The Corporation's residential real estate portfolio is comprised of one-to-four family residential mortgage loan originations, home equity term loans and home equity lines of credit. These loans are generated by the Corporation's marketing efforts, its present customers, walk-in customers and referrals. These loans originate primarily within or with customers from the Corporation's market area.

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The Corporation's one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The Corporation offers fixed-rate mortgage loans with terms up to a maximum of thirty years for both permanent structures and those under construction. Loans with terms of thirty years are normally held for sale and sold without recourse; most of the residential mortgages held in the Corporation's residential real estate portfolio have maximum terms of twenty years. Generally, the majority of the Corporation's residential mortgage loans originate with a loan-to-value of eighty percent or less, or those with primary mortgage insurance at ninety-five percent or less. Home equity term loans are secured by the borrower's primary residence and typically have a maximum loan-to-value of eighty percent and a maximum term of fifteen years. In general, home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of eighty percent and a maximum term of twenty years.

In underwriting one-to-four family residential mortgage loans, the Corporation evaluates the borrower's ability to make monthly payments, the borrower's repayment history and the value of the property securing the loan. The ability and willingness to repay is determined by the borrower's employment history, current financial conditions and credit background. A majority of the properties securing residential real estate loans made by the Corporation are appraised by independent appraisers. The Corporation generally requires mortgage loan borrowers to obtain an attorney's title opinion or title insurance and fire and property insurance, including flood insurance, if applicable.

Residential mortgage loans, home equity term loans and home equity lines of credit generally present a lower level of risk than consumer loans because they are secured by the borrower's primary residence. Risk is increased when the Corporation is in a subordinate position, especially to another lender, for the loan collateral.

#### *Consumer Lending*

The Corporation offers a variety of secured and unsecured consumer loans, including vehicle loans, stock loans and loans secured by financial institution deposits. These loans originate primarily within or with customers from the market area.

Consumer loan terms vary according to the type and value of collateral and creditworthiness of the borrower. In underwriting personal loans, a thorough analysis is performed regarding the borrower's willingness and financial ability to repay the loan as agreed. The ability to repay is determined by the borrower's employment history, current financial condition and credit background.

Consumer loans may entail greater credit risk than residential real estate loans, particularly in the case of personal loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles or recreational equipment. In such cases, repossessed collateral for a defaulted personal loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, personal loan collections are dependent on the borrower's continuing financial stability and therefore, are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

#### **Delinquent Loans**

Generally, a loan is considered to be past-due when scheduled loan payments are in arrears 10 days or more. Delinquent notices are generated automatically when a loan is 10 or 15 days past-due, depending on loan type. Collection efforts continue on past-due loans that have not been brought current, when it is believed that some chance exists for improvement in the status of the loan. Past-due loans are continually evaluated with the determination for charge-off being made when no reasonable chance remains that the status of the loan can be improved.

Commercial and Industrial and Commercial Real Estate loans are charged off in whole or in part when they become sufficiently delinquent based upon the terms of the underlying loan contract and when a collateral deficiency exists. Because all or part of the contractual cash flows are not expected to be collected, the loan is considered to be impaired, and the Bank estimates the impairment based on its analysis of the cash flows or collateral estimated at fair value less cost to sell.

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Residential Real Estate and Consumer loans are charged off when they become sufficiently delinquent based upon the terms of the underlying loan contract and when the value of the underlying collateral is not sufficient to support the loan balance and a loss is expected. At that time, the amount of estimated collateral deficiency, if any, is charged off for loans secured by collateral, and all other loans are charged off in full. Loans with collateral are charged down to the estimated fair value of the collateral less cost to sell.

Loans in which the borrower is in bankruptcy are considered on a case by case basis and are either charged off or reaffirmed by the borrower.

Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan may currently be performing. A loan may remain on accrual status if it is well secured (or supported by a strong guarantee) and in the process of collection. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against interest income. Certain non-accrual loans may continue to perform; that is, payments are still being received. Generally, the payments are applied to principal. These loans remain under constant scrutiny, and if performance continues, interest income may be recorded on a cash basis based on management's judgment as to collectability of principal.

**Allowance for Loan Losses**

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level estimated by management to be adequate to absorb potential loan losses. Management's periodic evaluation of the adequacy of the allowance for loan losses is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions, and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are individually classified as impaired. Select loans are not aggregated for collective impairment evaluation, as such; all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular loan suggest that such evaluation is necessary. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from collateral. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan may be reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

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The general component covers all other loans not identified as impaired and is based on historical losses and qualitative factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over a time period that management has determined represents the current credit cycle. Qualitative factors impacting each portfolio segment may include: delinquency trends, loan volume trends, Bank policy changes, management processes and oversight, economic trends (including change in consumer and business disposable incomes, unemployment and under-employment levels, and other conditions), concentrations by industry or product, internal and external loan review processes, collateral value and market conditions, and external factors including regulatory issues and competition.

The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A reserve for unfunded lending commitments is provided for possible credit losses on off-balance sheet credit exposures. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and, if necessary, is recorded in other liabilities on the Consolidated Balance Sheets. As of December 31, 2017 and 2016 the amount of the reserve for unfunded lending commitments was \$116,000 and \$202,000, respectively.

The Corporation is subject to periodic examination by its federal and state examiners, and may be required by such regulators to recognize additions to the allowance for loan losses based on their assessment of credit information available to them at the time of their examinations.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the original loan agreement. Under current accounting standards, the allowance for loan losses related to impaired loans is based on discounted cash flows using the loan's effective interest rate at inception or the fair value of the collateral for certain collateral dependent loans.

The restructuring of a loan is considered a "troubled debt restructuring" if both the following conditions are met: (i) the borrower is experiencing financial difficulties, and (ii) the Bank has granted a concession. The most common concessions granted include one or more modifications to the terms of the debt, such as (a) a reduction in the interest rate for the remaining life of the debt, (b) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (c) a temporary period of interest-only payments, and (d) a reduction in the contractual payment amount for either a short period or remaining term of the loan. A less common concession is the forgiveness of a portion of the principal.

The determination of whether a borrower is experiencing financial difficulties takes into account not only the current financial condition of the borrower, but also the potential financial condition of the borrower were a concession not granted. Similarly, the determination of whether a concession has been granted is very subjective in nature. For example, simply extending the term of a loan at its original interest rate or even at a higher interest rate could be interpreted as a concession unless the borrower could readily obtain similar credit terms from a different lender.

Loans modified in a troubled debt restructuring are considered impaired and may or may not be placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrates a period of performance according to the restructured terms of six months.

The Bank utilizes a risk grading matrix as a tool for managing credit risk in the loan portfolio and assigns an asset quality rating (risk grade) to all Commercial and Industrial, Commercial Real Estate, Residential Real Estate and Consumer borrowings. An asset quality rating is assigned using the guidance provided in the Bank's loan policy. Primary responsibility for assigning the asset quality rating rests with the lender. The asset quality rating is validated periodically by both an internal and external loan review process.

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The commercial loan grading system focuses on a borrower's financial strength and performance, experience and depth of management, primary and secondary sources of repayment, the nature of the business and the outlook for the particular industry. Primary emphasis is placed on financial condition and trends. The grade also reflects current economic and industry conditions; as well as other variables such as liquidity, cash flow, revenue/earnings trends, management strengths or weaknesses, quality of financial information, and credit history.

The loan grading system for Residential Real Estate and Consumer loans focuses on the borrower's credit score and credit history, debt-to-income ratio and income sources, collateral position and loan-to-value ratio, as well as other variables such as current economic conditions, and individual strengths and weaknesses.

Risk grade characteristics are as follows:

*Risk Grade 1 – MINIMAL RISK through Risk Grade 6 – MANAGEMENT ATTENTION (Pass Grade Categories)*

Risk is evaluated via examination of several attributes including but not limited to financial trends, strengths and weaknesses, likelihood of repayment when considering both cash flow and collateral, sources of repayment, leverage position, management expertise, and repayment history.

At the low-risk end of the rating scale, a risk grade of 1 - Minimal Risk is the grade reserved for loans with exceptional credit fundamentals and virtually no risk of default or loss. Loan grades then progress through escalating ratings of 2 through 6 based upon risk. Risk Grade 2 - Modest Risk are loans with sufficient cash flows; Risk Grade 3 - Average Risk are loans with key balance sheet ratios slightly above the borrower's peers; Risk Grade 4 - Acceptable Risk are loans with key balance sheet ratios usually near the borrower's peers, but one or more ratios may be higher; and Risk Grade 5 – Marginally Acceptable are loans with strained cash flow, increasing leverage and/or weakening markets. Risk Grade 6 - Management Attention are loans with weaknesses resulting from declining performance trends and the borrower's cash flows may be temporarily strained. Loans in this category are performing according to terms, but present some type of potential concern.

*Risk Grade 7 – SPECIAL MENTION (Non-Pass Category)*

Generally, these loans or assets are currently protected, but are "potentially weak." They constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

Assets in this category are currently protected but have potential weakness which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. No loss of principal or interest is envisioned; however, they constitute an undue credit risk that may be minor but is unwarranted in light of the circumstances surrounding a specific asset. Risk is increasing beyond that at which the loan originally would have been granted. Historically, cash flows are inconsistent; financial trends show some deterioration. Liquidity and leverage are above industry averages. Financial information could be incomplete or inadequate. A Special Mention asset has potential weaknesses that deserve management's close attention.

*Risk Grade 8 – SUBSTANDARD (Non-Pass Category)*

Generally, these assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have "well-defined" weaknesses that jeopardize the full liquidation of the debt.

These loans are characterized by the distinct possibility that the Bank will sustain some loss if the aggregate amount of substandard assets is not fully covered by the liquidation of the collateral used as security. Substandard loans have a high probability of payment default and require more intensive supervision by Bank management.



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*Risk Grade 9 – DOUBTFUL (Non-Pass Category)*

Generally, loans graded doubtful have all the weaknesses inherent in a substandard loan with the added factor that the weaknesses are pronounced to a point whereby the basis of current information, conditions, and values, collection or liquidation in full is deemed to be highly improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to strengthen the asset, its classification is deferred until, for example, a proposed merger, acquisition, liquidation procedure, capital injection, perfection of liens on additional collateral and/or refinancing plan is completed. Loans are graded doubtful if they contain weaknesses so serious that collection or liquidation in full is questionable.

**Premises and Equipment**

Premises, improvements, and equipment are stated at cost less accumulated depreciation computed principally utilizing the straight-line method over the estimated useful lives of the assets. Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate that the carrying value may not be recovered. Maintenance and minor repairs are charged to operations as incurred. The cost and accumulated depreciation of the premises and equipment retired or sold are eliminated from the property accounts at the time of retirement or sale, and the resulting gain or loss is reflected in current operations.

**Mortgage Servicing Rights**

The Corporation originates and sells real estate loans to investors in the secondary mortgage market. After the sale, the Corporation may retain the right to service these loans. When originated mortgage loans are sold and servicing is retained, a servicing asset is capitalized based on relative fair value at the date of sale. Servicing assets are amortized as an offset to other fees in proportion to, and over the period of, estimated net servicing income. The servicing asset is included in other assets in the Consolidated Balance Sheets. Gains or losses on sales of mortgage loans are recognized based on the differences between the selling price and the carrying value of the related mortgage loans sold.

**Bank Owned Life Insurance**

The cash surrender value of bank owned life insurance is carried as an asset, and changes in cash surrender value are recorded as non-interest income.

The Bank entered into agreements to provide post-retirement benefits to two retired employees in the form of life insurance payable to the employee's beneficiaries upon their death through endorsement split dollar life insurance arrangements. The Bank's accrued liabilities for this benefit agreement as of December 31, 2017 and 2016 was \$41,000 and \$43,000, respectively. In 2015, there was a \$15,800 reduction in the expense related to the benefit agreement as a result of a correction to the accrual methodology for multiple plan participants. The related expense for this benefit agreement amounted to \$(1,000), \$(1,000) and \$(16,500) for the years ended December 31, 2017, 2016 and 2015, respectively.

**Investments in Low-Income Housing Partnerships**

The Bank is a limited partner in real estate ventures that own and operate affordable residential low-income housing apartment buildings for elderly and mentally challenged adult residents. The investments are accounted for under the cost method. Under the cost method, the Bank recognizes tax credits as they are allocated and amortizes the initial cost of the investment over the period that the tax credits are allocated to the Bank. The amount of tax credits allocated to the Bank were \$323,000 in 2017, \$230,000 in 2016, and \$230,000 in 2015, and the amortization of the investments in the limited partnerships were \$181,000, \$176,000 and \$167,000 in 2017, 2016 and 2015, respectively. During 2015, the Bank became a limited partner in a real estate venture with an initial investment of \$590,000, an additional capital contribution of \$1,178,000 made in 2016, plus capital contributions of \$252,000 made in 2017. The construction was completed and the property was occupied in 2017.

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**Goodwill and Core Deposit Intangibles**

Goodwill resulted from the acquisition of the Pocono Community Bank in November 2007 and of certain fixed and operating assets acquired and deposit liabilities assumed of the branch of another financial institution in Danville, Pennsylvania, in January 2004. Such goodwill represents the excess cost of the acquired assets relative to the assets fair value at the dates of acquisition. During the first quarter of 2008, \$152,000 of liabilities related to the Pocono acquisition were recorded as a purchase accounting adjustment resulting in an increase in the excess purchase price. The amount was comprised of the finalization of severance agreements and contract terminations related to the acquisition. In accordance with current accounting standards, goodwill is not amortized. Management performs an annual evaluation for impairment. Any impairment of goodwill results in a charge to income. The Corporation periodically assesses whether events or changes in circumstances indicate that the carrying amounts of goodwill and other intangible assets may be impaired. Goodwill is evaluated for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The Corporation has evaluated the goodwill included in its consolidated balance sheet at September 30, 2017, and has determined there was no impairment as of that date. In addition, the Corporation did not identify any impairment in 2016 or 2015. No assurance can be given that future impairment tests will not result in a charge to earnings.

Intangible assets are comprised of core deposit intangibles and premium discount (negative premium) on certificates of deposit acquired. The core deposit intangible was being amortized over the average life of the deposits acquired as determined by an independent third party. Premium discount (negative premium) on acquired certificates of deposit resulted from the valuation of certificate of deposit accounts by an independent third party. The book value of certificates of deposit acquired was greater than their fair value at the date of acquisition which resulted in a negative premium due to higher cost of the certificates of deposit compared to the cost of similar term financing. The core deposit intangible was subject to impairment testing whenever events or changes in circumstances indicate its carrying amount may not reflect its benefit. As of June 30, 2015, the core deposit intangible was fully amortized.

**Stock Based Compensation**

The Corporation adopted a stock option incentive plan in 1998. Compensation cost is recognized for stock options to employees based on the fair value of these awards at the date of grant. A Black-Scholes Option Pricing Model is utilized to estimate the fair value of stock options. Compensation expense is recognized over the requisite service period. The Plan expired in 2008, and therefore, no stock options are available for issuance. After adjustments for the effects of stock dividends, options exercised and options forfeited, there are no exercisable options issued and outstanding as of December 31, 2017.

**Foreclosed Assets Held for Resale**

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell on the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed and if fair value less costs to sell declines subsequent to foreclosure, a valuation allowance is recorded through expense. Revenues derived from and costs to maintain the assets and subsequent gains and losses on sales are included in non-interest expense on the Consolidated Statements of Income.

**Income Taxes**

The Corporation accounts for income taxes in accordance with income tax accounting guidance FASB ASC Topic 740, *Income Taxes*.

Current income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Corporation determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

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Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of the evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Corporation accounts for uncertain tax positions if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more-likely-than-not means a likelihood of more than 50%; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment.

The Corporation recognizes interest and penalties on income taxes, if any, as a component of income tax expense.

**Earnings Per Share**

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Corporation. Potential common shares that may be issued by the Corporation relate solely to outstanding stock options and are determined using the treasury stock method. The following table sets forth the computation of basic and diluted earnings per share.

*(In thousands, except earnings per share)*

	Year Ended December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
Net income	\$ 8,648	\$ 9,472	\$ 9,172
Weighted-average common shares outstanding	<u>5,689</u>	<u>5,640</u>	<u>5,588</u>
<b>Basic earnings per share</b>	<u>\$ 1.52</u>	<u>\$ 1.68</u>	<u>\$ 1.64</u>
Weighted-average common shares outstanding	5,689	5,640	5,588
Common stock equivalents due to effect of stock options	<u>—</u>	<u>2</u>	<u>2</u>
Total weighted-average common shares and equivalents	<u>5,689</u>	<u>5,642</u>	<u>5,590</u>
<b>Diluted earnings per share</b>	<u>\$ 1.52</u>	<u>\$ 1.68</u>	<u>\$ 1.64</u>

**Treasury Stock**

The purchase of the Corporation's common stock is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of such stock on a first-in-first-out basis.

**Trust Assets and Revenues**

Property held by the Corporation in a fiduciary or agency capacity for its customers is not included in the accompanying consolidated financial statements since such items are not assets of the Corporation. Assets held in Trust were \$111,130,000 and \$110,167,000 at December 31, 2017 and 2016, respectively. Trust Department income is generally recognized on a cash basis and is not materially different than if it were reported on an accrual basis.

**Comprehensive Income (Loss)**

The Corporation is required to present accumulated other comprehensive income (loss) in a full set of general-purpose financial statements for all periods presented. Accumulated other comprehensive income (loss) is comprised of net unrealized holding gains (losses) on the available-for-sale investment securities portfolio and unrealized losses related to equity securities which have been determined to be other-than temporarily impaired. The Corporation has elected to report these effects on the Consolidated Statements of Comprehensive Income.

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**Advertising Costs**

It is the Corporation's policy to expense advertising costs in the period in which they are incurred.

**Recent Accounting Standards Updates ("ASU")**

Except as disclosed below, there were no new accounting pronouncements affecting the Corporation during the year ended December 31, 2017 that were not already adopted by the Corporation in previous periods.

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue requirements in *Revenue Recognition (Topic 605)*. This ASU requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. Several additional ASUs have been issued subsequently to ASU 2014-09 to provide clarifying guidance related to various revenue recognition areas and to defer the effective date of the standard by a year, making it applicable for the Corporation in the first quarter 2018 and for the annual period ending December 31, 2018. Management has determined that approximately 87% of the Corporation's revenue is out of the scope of ASU 2014-09, including all of the Corporation's net interest income and a significant portion of the non-interest income. Management has evaluated the non-interest revenue streams and adoption of ASU 2014-09 using the modified retrospective method had no material effect on the Corporation's revenue recognition practices. Additionally, the ASU requires expanded disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue that is recognized. Management is in the process of reviewing the Corporation's business process, systems and controls to support the expanded disclosure requirements that will be effective in the first quarter 2018.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. In particular, the guidance revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The guidance also amends certain disclosure requirements associated with fair value of financial instruments. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The FASB issued ASU 2018-03 on February 28, 2018, *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10)*, which clarifies the guidance in ASU No. 2016-01 on several issues, such as Equity Securities without a Readily Determinable Fair Value – Discontinuation. The adoption of this standard will not have a material effect on the Corporation's operating results or financial condition. The Corporation's restricted investment in bank stocks consists of one correspondent bank stock (Federal Home Loan Bank), which does not have a readily determinable market value; therefore, has no effect. The Corporation's investments in low income housing partnerships are accounted for under the cost method; therefore, there is no impact. The Corporation has updated its policies and procedures to report its financial instruments at exit price and to recognize the changes in fair value of applicable equity investments in net income beginning in the first quarter of 2018.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted for all public business entities upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The adoption of this ASU will result in an increase to the Consolidated Balance Sheets for right-of-use assets and associated lease liabilities for operating leases in which the Corporation is the lessee. The Corporation is in the early stages of evaluating the significance and other effects of adoption on the consolidated Financial Statements and related disclosures.

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In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU requires that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. This is in contrast to existing guidance whereby credit losses generally are not recognized until they are incurred. For public companies, this update will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. While the Corporation is currently evaluating the provisions of the ASU to determine the potential impact of the new standard will have on the Corporation's Consolidated Financial Statements, it has taken steps to prepare for the implementation when it becomes effective, such as forming an internal committee, gathering pertinent data, consulting with outside professionals, and begun evaluating its current IT systems.

In August 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. The amendments are intended to reduce diversity in practice. The guidance clarifies the classification of various business activities as financing, operating or investing activity. The ASU contains additional guidance clarifying when an entity should separate cash receipts and cash payments and classify them into more than one class of cash flows (including when reasonable judgment is required to estimate and allocate cash flows) versus when an entity should classify the aggregate amount into one class of cash flows on the basis of predominance. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The Corporation anticipates there will be no adjustments to the Consolidated Statements of Cash Flows as a result of the clarifications provided in the ASU.

In November 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-18, *Statement of Cash flows—Restricted Cash (Topic 230)*. The amendments in this Update clarify the inclusion of restricted cash, see Note 2 – Restricted Cash Balances, in the cash and cash equivalents beginning-of-period and end-of period reconciliation on the consolidated statement of cash flows. For public business entities that are SEC filers, such as the Corporation, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Because this amendment primarily impacts the presentation and classification of information, the Corporation does not expect this ASU to have an impact on the Corporation's consolidated financial statements and results of operations. The Corporation is currently in the process of implementing this ASU for the first quarter of 2018.

In January 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Instead, under the amendments, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value with its carrying amount. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount when measuring the goodwill impairment loss, if applicable. The update also eliminated the requirements for zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendments are effective for public business entities for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In March 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-07, *Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The amendments apply to all entities that offer employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715, Compensation — Retirement Benefits. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments also allow only the service cost component to be eligible for capitalization when applicable (e.g., as a cost of internally manufactured inventory or a self-constructed asset). The ASU is effective for public business entities for annual periods

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beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In March 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-08, *Receivables- Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The ASU shortens the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Corporation is currently assessing the impact that this guidance will have on its consolidated financial statements and related disclosures.

In February 2018, the Financial Accounting Standards Board ("FASB") issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("AOCI")*. This ASU provides financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) are recorded. Effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Corporation is currently assessing and considering what effects early adoption may have on its consolidated financial statements and related disclosures.

#### **Transfer of Financial Assets**

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

#### **Off-Balance Sheet Financial Instruments**

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the Consolidated Balance Sheets when they are funded.

#### **Reclassifications**

Certain amounts previously reported have been reclassified, when necessary, to conform with presentations used in the 2017 consolidated financial statements. Such reclassifications have no effect on the Corporation's net income.

#### **NOTE 2 — RESTRICTED CASH BALANCES**

The Bank is required to maintain certain average reserve balances as established by the Federal Reserve Bank. The amount of those reserve balances for the reserve computation period which included December 31, 2017 and 2016, was \$1,402,000 and \$1,495,000, respectively, which was satisfied through the restriction of vault cash. In addition, the Bank maintains a clearing balance at the Federal Reserve Bank to offset daily cash management activities and specific charges for services. At December 31, 2017 and 2016, the amount of this balance was \$815,000 and \$779,000, respectively.

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**NOTE 3 — INVESTMENT SECURITIES**

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as “Available-For-Sale” or “Held-to-Maturity” were as follows at December 31, 2017 and 2016:

*(Dollars in thousands)*

	Available-for-Sale Securities			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<b>December 31, 2017:</b>				
U.S. Treasury securities	\$ —	\$ —	\$ —	\$ —
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	82,825	210	(1,175)	81,860
Other	22,409	132	(308)	22,233
Obligations of state and political subdivisions	211,743	4,690	(911)	215,522
Corporate debt securities	29,645	90	(764)	28,971
Marketable equity securities	740	892	—	1,632
<b>Total</b>	<b>\$347,362</b>	<b>\$ 6,014</b>	<b>\$(3,158)</b>	<b>\$350,218</b>

*(Dollars in thousands)*

	Held-to-Maturity Securities			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<b>December 31, 2017:</b>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ —	\$ —	\$ —	\$ —
<b>Total</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ —</b>

*(Dollars in thousands)*

	Available-for-Sale Securities			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<b>December 31, 2016:</b>				
U.S. Treasury securities	\$ 1,008	\$ 2	\$ —	\$ 1,010
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	112,155	83	(1,331)	110,907
Other	21,399	82	(511)	20,970
Obligations of state and political subdivisions	211,154	2,776	(2,796)	211,134
Corporate debt securities	35,178	4	(1,206)	33,976
Marketable equity securities	810	830	—	1,640
<b>Total</b>	<b>\$381,704</b>	<b>\$ 3,777</b>	<b>\$(5,844)</b>	<b>\$ 379,637</b>

*(Dollars in thousands)*

	Held-to-Maturity Securities			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
<b>December 31, 2016:</b>				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 4	\$ —	\$ —	\$ 4
<b>Total</b>	<b>\$ 4</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 4</b>

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Securities Available-for-Sale with an aggregate fair value of \$290,104,000 at December 31, 2017 and \$320,319,000 at December 31, 2016, and securities Held-to-Maturity with an aggregate book value of \$0 at December 31, 2017 and \$4,000 at December 31, 2016, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, debtor in possession funds and FHLB advances aggregating \$224,659,000 at December 31, 2017 and \$221,818,000 at December 31, 2016.

The amortized cost and fair value of securities, by contractual maturity, are shown below at December 31, 2017. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

*(Dollars in thousands)*

	<u>Available for Sale</u>		<u>Held to Maturity</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
1 year or less	\$ 1,547	\$ 1,549	\$ —	\$ —
Over 1 year through 5 years	37,048	37,098	—	—
Over 5 years through 10 years	103,609	103,369	—	—
Over 10 years	121,593	124,710	—	—
Mortgage-backed securities	82,825	81,860	—	—
Marketable equity securities	740	1,632	—	—
	<u>\$ 347,362</u>	<u>\$ 350,218</u>	<u>\$ —</u>	<u>\$ —</u>

There were no aggregate investments with a single issuer (excluding the U.S. Government and its political subdivisions and agencies) which exceeded ten percent of consolidated stockholders' equity at December 31, 2017. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poor's or Fitch. The typical exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities.

Proceeds from sales of investments in Available-for-Sale debt and equity securities during 2017, 2016 and 2015 were \$81,807,000, \$76,759,000 and \$111,799,000, respectively. Gross gains realized on these sales were \$1,024,000, \$1,907,000 and \$2,186,000, respectively. Gross losses on these sales were \$86,000, \$143,000 and \$55,000, respectively. Impairment losses realized on Available-for-Sale equity securities were \$0, \$0 and \$14,000, respectively.

There were no proceeds from sales of investments in Held-to-Maturity debt and equity securities during 2017, 2016 and 2015. Therefore, there were no gains or losses realized during these periods.

The Corporation and its investment advisors monitor the entire portfolio monthly with particular attention given to securities in a continuous loss position of at least ten percent for over twelve months. As of June 30, 2015, we recognized other than temporary impairment on one equity security that was trading below cost basis. We have written down the value of the shares based upon market indications. In management's opinion, the equity securities reflect a more accurate valuation of the shares after the impairment charge. Based on the factors described above, management did not consider any additional securities to be other-than-temporarily impaired at December 31, 2017 and 2016.



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In accordance with disclosures required by FASB ASC 320-10-50, *Investments - Debt and Equity Securities*, the summary below shows the gross unrealized losses and fair value of the Corporation's investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or 12 months or more as of December 31, 2017 and 2016:

**December 31, 2017**

*(Dollars in thousands)*

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
<b>Available-for-Sale:</b>						
U.S. Treasury securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	30,555	(300)	33,943	(875)	64,498	(1,175)
Other	2,905	(4)	7,179	(304)	10,084	(308)
Obligations of state and political subdivisions	36,149	(329)	22,566	(582)	58,715	(911)
Corporate debt securities	6,746	(24)	15,174	(740)	21,920	(764)
Marketable equity securities	—	—	—	—	—	—
	<u>\$ 76,355</u>	<u>\$ (657)</u>	<u>\$ 78,862</u>	<u>\$ (2,501)</u>	<u>\$ 155,217</u>	<u>\$ (3,158)</u>

**December 31, 2016**

*(Dollars in thousands)*

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
<b>Available-for-Sale:</b>						
U.S. Treasury securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	89,444	(1,216)	8,783	(115)	98,227	(1,331)
Other	10,340	(500)	1,741	(11)	12,081	(511)
Obligations of state and political subdivisions	95,481	(2,796)	—	—	95,481	(2,796)
Corporate debt securities	21,656	(749)	10,298	(457)	31,954	(1,206)
Marketable equity securities	—	—	—	—	—	—
	<u>\$ 216,921</u>	<u>\$ (5,261)</u>	<u>\$ 20,822</u>	<u>\$ (583)</u>	<u>\$ 237,743</u>	<u>\$ (5,844)</u>

The Corporation invests in various forms of agency debt including mortgage backed securities and callable debt. The mortgage backed securities are issued by FHLMC ("Federal Home Loan Mortgage Corporation"), FNMA ("Federal National Mortgage Association") or GNMA ("Government National Mortgage Association"). The municipal securities consist of general obligations and revenue bonds. The marketable equity securities consist of stocks in other bank holding companies. The fair market value of the above securities is influenced by market interest rates, prepayment speeds on mortgage securities, bid-offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation's carrying value at any measurement date. Management does not believe any of their 51 securities with a one year or less unrealized loss position or any of their 47 securities with a greater than one year unrealized loss position as of December 31, 2017, represent an other-than-temporary impairment, as these unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

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**NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES**

The following table presents the classes of the loan portfolio summarized by risk rating as of December 31, 2017 and 2016:

<i>(Dollars in thousands)</i>	Commercial and Industrial		Commercial Real Estate	
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Grade:				
1-6 Pass	\$ 97,832	\$ 78,319	\$ 276,682	\$ 243,023
7 Special Mention	10	4,425	1,514	6,224
8 Substandard	1,334	684	12,210	13,817
9 Doubtful	—	—	—	—
Add (deduct): Unearned discount and Net deferred loan fees and costs	161	145	564	455
Total loans	<u>\$ 99,337</u>	<u>\$ 83,573</u>	<u>\$ 290,970</u>	<u>\$ 263,519</u>

	Residential Real Estate Including Home Equity		Consumer Loans	
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Grade:				
1-6 Pass	\$ 161,405	\$ 165,862	\$ 5,997	\$ 6,073
7 Special Mention	124	1,664	52	71
8 Substandard	1,444	1,523	24	9
9 Doubtful	—	—	—	—
Add (deduct): Unearned discount and Net deferred loan fees and costs	(1)	(6)	—	—
	(47)	(8)	92	102
Total loans	<u>\$ 162,925</u>	<u>\$ 169,035</u>	<u>\$ 6,165</u>	<u>\$ 6,255</u>

	Total Loans	
	<u>2017</u>	<u>2016</u>
Grade:		
1-6 Pass	\$ 541,916	\$ 493,277
7 Special Mention	1,700	12,384
8 Substandard	15,012	16,033
9 Doubtful	—	—
Add (deduct): Unearned discount and Net deferred loan fees and costs	(1)	(6)
	770	694
Total loans	<u>\$ 559,397</u>	<u>\$ 522,382</u>

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of \$40,926,000 and \$2,315,000 at December 31, 2017 and \$36,289,000 and \$2,780,000 at December 31, 2016. Loans held for sale amounted to \$834,000 at December 31, 2017 and \$100,000 at December 31, 2016.

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The activity in the allowance for loan losses, by loan class, is summarized below for the years indicated.

<i>(Dollars in thousands)</i>	<u>Commercial and Industrial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
<b>2017</b>						
Allowance for Loan Losses:						
Beginning balance	\$ 836	\$ 4,421	\$ 1,777	\$ 95	\$ 228	\$ 7,357
Charge-offs	—	(189)	(62)	(82)	—	(333)
Recoveries	74	103	9	10	—	196
Provision	39	(268)	(68)	88	476	267
Ending Balance	<u>\$ 949</u>	<u>\$ 4,067</u>	<u>\$ 1,656</u>	<u>\$ 111</u>	<u>\$ 704</u>	<u>\$ 7,487</u>
Ending balance: individually evaluated for impairment	<u>\$ —</u>	<u>\$ 305</u>	<u>\$ 22</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 327</u>
Ending balance: collectively evaluated for impairment	<u>\$ 949</u>	<u>\$ 3,762</u>	<u>\$ 1,634</u>	<u>\$ 111</u>	<u>\$ 704</u>	<u>\$ 7,160</u>
Loans Receivable:						
Ending Balance	<u>\$ 99,337</u>	<u>\$ 290,970</u>	<u>\$ 162,925</u>	<u>\$ 6,165</u>	<u>\$ —</u>	<u>\$ 559,397</u>
Ending balance: individually evaluated for impairment	<u>\$ 1,203</u>	<u>\$ 11,673</u>	<u>\$ 1,050</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 13,926</u>
Ending balance: collectively evaluated for impairment	<u>\$ 98,134</u>	<u>\$ 279,297</u>	<u>\$ 161,875</u>	<u>\$ 6,165</u>	<u>\$ —</u>	<u>\$ 545,471</u>
 <i>(Dollars in thousands)</i>						
	<u>Commercial and Industrial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
<b>2016</b>						
Allowance for Loan Losses:						
Beginning balance	\$ 725	\$ 3,983	\$ 1,777	\$ 96	\$ 158	\$ 6,739
Charge-offs	(195)	(1,200)	(61)	(38)	—	(1,494)
Recoveries	9	—	12	8	—	29
Provision	297	1,638	49	29	70	2,083
Ending Balance	<u>\$ 836</u>	<u>\$ 4,421</u>	<u>\$ 1,777</u>	<u>\$ 95</u>	<u>\$ 228</u>	<u>\$ 7,357</u>
Ending balance: individually evaluated for impairment	<u>\$ —</u>	<u>\$ 200</u>	<u>\$ 19</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 219</u>
Ending balance: collectively evaluated for impairment	<u>\$ 836</u>	<u>\$ 4,221</u>	<u>\$ 1,758</u>	<u>\$ 95</u>	<u>\$ 228</u>	<u>\$ 7,138</u>
Loans Receivable:						
Ending Balance	<u>\$ 83,573</u>	<u>\$ 263,519</u>	<u>\$ 169,035</u>	<u>\$ 6,255</u>	<u>\$ —</u>	<u>\$ 522,382</u>
Ending balance: individually evaluated for impairment	<u>\$ 416</u>	<u>\$ 12,873</u>	<u>\$ 1,008</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 14,297</u>
Ending balance: collectively evaluated for impairment	<u>\$ 83,157</u>	<u>\$ 250,646</u>	<u>\$ 168,027</u>	<u>\$ 6,255</u>	<u>\$ —</u>	<u>\$ 508,085</u>

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<i>(Dollars in thousands)</i>	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
2015						
Allowance for Loan Losses:						
Beginning balance	\$ 542	\$ 3,176	\$ 1,928	\$ 107	\$ 637	\$ 6,390
Charge-offs	(2)	(1,759)	(210)	(45)	—	(2,016)
Recoveries	22	59	1	6	—	88
Provision	163	2,507	58	28	(479)	2,277
Ending Balance	<u>\$ 725</u>	<u>\$ 3,983</u>	<u>\$ 1,777</u>	<u>\$ 96</u>	<u>\$ 158</u>	<u>\$ 6,739</u>
Ending balance: individually evaluated for impairment	<u>\$ —</u>	<u>\$ 309</u>	<u>\$ 31</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 340</u>
Ending balance: collectively evaluated for impairment	<u>\$ 725</u>	<u>\$ 3,674</u>	<u>\$ 1,746</u>	<u>\$ 96</u>	<u>\$ 158</u>	<u>\$ 6,399</u>
Loans Receivable:						
Ending Balance	<u>\$ 85,074</u>	<u>\$ 259,018</u>	<u>\$ 166,628</u>	<u>\$ 5,890</u>	<u>\$ —</u>	<u>\$ 516,610</u>
Ending balance: individually evaluated for impairment	<u>\$ 399</u>	<u>\$ 12,057</u>	<u>\$ 911</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 13,367</u>
Ending balance: collectively evaluated for impairment	<u>\$ 84,675</u>	<u>\$ 246,961</u>	<u>\$ 165,717</u>	<u>\$ 5,890</u>	<u>\$ —</u>	<u>\$ 503,243</u>

Of the \$1,071,000 in foreclosed assets held for resale at December 31, 2017, \$15,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,006,000 was secured by commercial real estate. All foreclosed assets were held as the result of obtaining physical possession. Of the \$1,273,000 in foreclosed assets held for resale at December 31, 2016, \$50,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,173,000 was secured by commercial real estate. Consumer mortgage loans secured by residential real estate for which the Bank has entered into formal foreclosure proceedings but for which physical possession of the property has yet to be obtained amounted to \$485,000 at December 31, 2017 and \$649,000 at December 31, 2016. These balances were not included in foreclosed assets held for resale at December 31, 2017 and 2016.

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where the modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR").

The outstanding recorded investment of loans categorized as TDRs as of December 31, 2017 and December 31, 2016 was \$9,109,000 and \$11,629,000, respectively. The decrease in TDRs at December 31, 2017 as compared to December 31, 2016 is attributable to large principal payments and pay-downs made on existing TDRs net against smaller loans modified as TDRs during the year ended December 31, 2017. As of December 31, 2017 and 2016, there were \$0 and \$2,000, respectively in unfunded commitments on TDRs.

For the year ended December 31, 2017, four loans with a combined post modification balance of \$1,170,000 were classified as TDRs, as compared to the years ended December 31, 2016 and 2015 when nine loans with a combined post modification balance of \$2,402,000 and eight loans with a combined post modification balance of \$8,767,000, respectively, were classified as TDRs. The loan modifications for the year ended December 31, 2017 consisted of one term modification beyond the original stated term and three payment modifications. The loan modifications for the year ended December 31, 2016 consisted of six term modifications beyond the original stated term and three payment modifications. The loan modifications for the year ended December 31, 2015 consisted of five term modifications beyond the original stated term, and three payment modifications.

During the year ended December 31, 2017, four existing TDRs experienced subsequent modifications. Two existing Commercial and Industrial TDRs to the owner of a greenhouse were subsequently modified during the year ended December 31, 2017; one TDR in the amount of \$309,000 was subsequently modified during the second quarter of 2017 to extend the maturity date of the loan and change payments to interest-only with all other accrued interest and principal due in full at maturity, and one TDR in the amount of \$70,000 was subsequently modified during the fourth quarter of 2017 to defer the contractually-due annual principal payment to the existing maturity date of October 2018, while requiring receipt of the 2017 annual interest payment. Both TDRs retain their original classification as "payment" modifications as of December 31, 2017. An existing Commercial Real Estate

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TDR to a travel agency in the amount of \$38,000 was subsequently modified during the second quarter of 2017 to allow interest only payments through April 2018, after which time the regular principal and interest payments will commence. The TDR retains its original classification as a “payment” modification as of December 31, 2017. An existing Commercial Real Estate TDR to a developer of a residential sub-division in the amount of \$1,664,000 was subsequently modified during the fourth quarter of 2017 to extend the maturity date to October 2020, reset the interest rate from a floating rate to a fixed rate, commence regular principal and interest payments, and take additional real estate collateral. The TDR retains its original classification as a “term” modification as of December 31, 2017.

The following table presents the outstanding recorded investment of TDRs at the dates indicated:

*(Dollars in thousands)*

	<u>December 31,</u> <u>2017</u>	<u>December 31,</u> <u>2016</u>	<u>December 31,</u> <u>2015</u>
Non-accrual TDRs	\$ 273	\$ 267	\$ 477
Accruing TDRs	<u>8,836</u>	<u>11,362</u>	<u>10,619</u>
Total	<u>\$ 9,109</u>	<u>\$ 11,629</u>	<u>\$ 11,096</u>

At December 31, 2017, six Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$340,000 and one Residential Real Estate loan classified as a TDR with a recorded investment of \$60,000 were not in compliance with the terms of their restructure, compared to December 31, 2016 when ten Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$810,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of \$15,000 were not in compliance with the terms of their restructure and December 31, 2015 when two Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$249,000 were not in compliance with the terms of their restructure.

During the twelve months ended December 31, 2017, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults, as compared to the same periods in 2016 and 2015 when one Commercial and Industrial loan in the amount of \$15,000 and one Commercial Real Estate loan in the amount of \$49,000, both modified as TDRs within the twelve months preceding December 31, 2016 and four Commercial Real Estate loans totaling \$4,382,000 that were modified as TDRs within the twelve months preceding December 31, 2015 had experienced payment defaults. The significant increase in defaulted TDRs at December 31, 2015 as compared to December 31, 2016 is largely due to one loan to a student housing holding company with a balance of \$4,204,000 at December 31, 2015, which was modified as a TDR during the first quarter of 2015 and experienced its subsequent default during the second quarter of 2015.

The following table presents information regarding the loan modifications categorized as TDRs during the years ended December 31, 2017, 2016, and 2015:

*(Dollars in thousands)*

	<u>Year Ended December 31, 2017</u>			
	<u>Number</u> <u>of Contracts</u>	<u>Pre-Modification</u> <u>Outstanding Recorded</u> <u>Investment</u>	<u>Post-Modification</u> <u>Outstanding Recorded</u> <u>Investment</u>	<u>Year-End</u> <u>Recorded</u> <u>Investment</u>
Commercial and Industrial	1	\$ 38	\$ 38	\$ 36
Commercial Real Estate	2	1,064	1,072	1,069
Residential Real Estate	<u>1</u>	<u>32</u>	<u>60</u>	<u>60</u>
Total	<u>4</u>	<u>\$ 1,134</u>	<u>\$ 1,170</u>	<u>\$ 1,165</u>

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(Dollars in thousands)

	Year Ended December 31, 2016			
	Number of Contracts	Pre-Modification	Post-Modification	Year-End
		Outstanding Recorded Investment	Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	4	\$ 86	\$ 86	\$ 21
Commercial Real Estate	5	2,316	2,316	2,001
Residential Real Estate	—	—	—	—
Total	<u>9</u>	<u>\$ 2,402</u>	<u>\$ 2,402</u>	<u>\$ 2,022</u>

(Dollars in thousands)

	Year Ended December 31, 2015			
	Number of Contracts	Pre-Modification	Post-Modification	Year-End
		Outstanding Recorded Investment	Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	1	\$ 23	\$ 23	\$ 20
Commercial Real Estate	7	8,612	8,744	8,727
Residential Real Estate	—	—	—	—
Total	<u>8</u>	<u>\$ 8,635</u>	<u>\$ 8,767</u>	<u>\$ 8,747</u>

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the years ended December 31, 2017, 2016, and 2015 with the total number of each type of modification performed.

	Year Ended December 31, 2017				Year Ended December 31, 2016			
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	—	—	1	1	—	3	1	4
Commercial Real Estate	—	1	1	2	—	3	2	5
Residential Real Estate	—	—	1	1	—	—	—	—
Total	<u>—</u>	<u>1</u>	<u>3</u>	<u>4</u>	<u>—</u>	<u>6</u>	<u>3</u>	<u>9</u>

	Year Ended December 31, 2015			
	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	—	1	—	1
Commercial Real Estate	—	4	3	7
Residential Real Estate	—	—	—	—
Total	<u>—</u>	<u>5</u>	<u>3</u>	<u>8</u>

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The recorded investment, unpaid principal balance, and the related allowance of the Corporation's impaired loans are summarized below for the periods ended December 31, 2017 and 2016.

*(Dollars in thousands)*

	<u>December 31, 2017</u>			<u>December 31, 2016</u>		
	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>
With no related allowance recorded:						
Commercial and Industrial	\$ 1,203	\$ 1,203	\$ —	\$ 416	\$ 416	\$ —
Commercial Real Estate	9,199	11,383	—	11,905	14,352	—
Residential Real Estate	878	1,024	—	584	745	—
With an allowance recorded:						
Commercial and Industrial	—	—	—	—	—	—
Commercial Real Estate	2,474	3,889	305	968	2,383	200
Residential Real Estate	172	172	22	424	424	19
Total	<u>\$ 13,926</u>	<u>\$ 17,671</u>	<u>\$ 327</u>	<u>\$ 14,297</u>	<u>\$ 18,320</u>	<u>\$ 219</u>
Total consists of:						
Commercial and Industrial	<u>\$ 1,203</u>	<u>\$ 1,203</u>	<u>\$ —</u>	<u>\$ 416</u>	<u>\$ 416</u>	<u>\$ —</u>
Commercial Real Estate	<u>\$ 11,673</u>	<u>\$ 15,272</u>	<u>\$ 305</u>	<u>\$ 12,873</u>	<u>\$ 16,735</u>	<u>\$ 200</u>
Residential Real Estate	<u>\$ 1,050</u>	<u>\$ 1,196</u>	<u>\$ 22</u>	<u>\$ 1,008</u>	<u>\$ 1,169</u>	<u>\$ 19</u>

At December 31, 2017 and 2016, \$9,109,000 and \$11,629,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of \$2,000 and \$0, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid balance is equal to the gross amount due on the loan.

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The average recorded investment and interest income recognized for the Corporation's impaired loans are summarized below for the years ended December 31, 2017, 2016 and 2015.

*(Dollars in thousands)*

	<b>For the Year Ended December 31, 2017</b>		For the Year Ended December 31, 2016		For the Year Ended December 31, 2015	
	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:						
Commercial and Industrial	\$ 1,032	\$ 25	\$ 435	\$ 17	\$ 404	\$ 16
Commercial Real Estate	11,140	485	11,434	528	5,971	280
Residential Real Estate	789	7	426	7	421	3
Consumer	—	—	—	—	2	—
With an allowance recorded:						
Commercial and Industrial	—	—	—	—	—	—
Commercial Real Estate	1,630	4	968	—	3,377	267
Residential Real Estate	215	—	427	—	443	—
Consumer	—	—	—	—	—	—
<b>Total</b>	<b>\$ 14,806</b>	<b>\$ 521</b>	<b>\$ 13,690</b>	<b>\$ 552</b>	<b>\$ 10,618</b>	<b>\$ 566</b>
Total consists of:						
Commercial and Industrial	\$ 1,032	\$ 25	\$ 435	\$ 17	\$ 404	\$ 16
Commercial Real Estate	\$ 12,770	\$ 489	\$ 12,402	\$ 528	\$ 9,348	\$ 547
Residential Real Estate	\$ 1,004	\$ 7	\$ 853	\$ 7	\$ 864	\$ 3
Consumer	\$ —	\$ —	\$ —	\$ —	\$ 2	\$ —

Of the \$521,000, \$552,000 and \$566,000 in interest income recognized on impaired loans for the years ended December 31, 2017, 2016 and 2015, respectively, \$20,000, \$13,000 and \$53,000 was recognized with respect to non-accrual loans.

Total non-performing assets (which includes loans receivable on non-accrual status, foreclosed assets held for resale and loans past-due 90 days or more and still accruing interest) as of December 31, 2017 and 2016 were as follows:

*(Dollars in thousands)*

	<b>December 31, 2017</b>	December 31, 2016
Commercial and Industrial	\$ 798	\$ —
Commercial Real Estate	3,302	1,927
Residential Real Estate	990	1,008
Total non-accrual loans	5,090	2,935
Foreclosed assets held for resale	1,071	1,273
Loans past-due 90 days or more and still accruing interest	70	34
<b>Total non-performing assets</b>	<b>\$ 6,231</b>	<b>\$ 4,242</b>

If interest on non-accrual loans had been accrued at original contract rates, interest income would have increased by \$328,000 in 2017, \$293,000 in 2016, and \$230,000 in 2015.



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The following tables present the classes of the loan portfolio summarized by the past-due status at December 31, 2017 and 2016:

*(Dollars in thousands)*

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days or Greater Past Due</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>90 Days Or Greater Past Due and Still Accruing Interest</u>
<b>December 31, 2017:</b>							
Commercial and Industrial	\$ 68	\$ 42	\$ —	\$ 110	\$ 99,227	\$ 99,337	\$ —
Commercial Real Estate	603	201	2,606	3,410	287,560	290,970	50
Residential Real Estate	1,952	484	584	3,020	159,905	162,925	20
Consumer	21	2	—	23	6,142	6,165	—
Total	<u>\$ 2,644</u>	<u>\$ 729</u>	<u>\$ 3,190</u>	<u>\$ 6,563</u>	<u>\$552,834</u>	<u>\$ 559,397</u>	<u>\$ 70</u>

*(Dollars in thousands)*

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days or Greater Past Due</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>90 Days Or Greater Past Due and Still Accruing Interest</u>
<b>December 31, 2016:</b>							
Commercial and Industrial	\$ 130	\$ —	\$ —	\$ 130	\$ 83,443	\$ 83,573	\$ —
Commercial Real Estate	1,019	273	1,927	3,219	260,300	263,519	—
Residential Real Estate	1,750	542	1,020	3,312	165,723	169,035	34
Consumer	28	8	—	36	6,219	6,255	—
Total	<u>\$ 2,927</u>	<u>\$ 823</u>	<u>\$ 2,947</u>	<u>\$ 6,697</u>	<u>\$515,685</u>	<u>\$ 522,382</u>	<u>\$ 34</u>

At December 31, 2017 and 2016, commitments to lend additional funds with respect to impaired loans consisted of three irrevocable letters of credit totaling \$1,268,000. One irrevocable letter of credit in the amount of \$1,249,000 was associated with a loan to a developer of a residential sub-division. Two irrevocable letters of credit totaling \$19,000 were associated with a loan to a non-profit community recreation facility.

**NOTE 5 — MORTGAGE SERVICING RIGHTS**

The mortgage loans sold and serviced for others are not included in the Consolidated Balance Sheets. The unpaid principal balances of mortgage loans serviced for others were \$100,179,000 and \$99,294,000 at December 31, 2017 and 2016, respectively. The balances of amortized capitalized mortgage servicing rights, included in other assets were \$379,000 at December 31, 2017 and \$431,000 at December 31, 2016. The amount of servicing income earned was \$246,000, \$245,000, and \$239,000 at December 31, 2017, 2016, and 2015, respectively. Amortization recognized in relation to mortgage servicing rights was \$135,000, \$136,000, and \$132,000 at December 31, 2017, 2016, and 2015, respectively. Both income and amortization are included in service charges and fees on the Consolidated Statements of Income.

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The following summarizes mortgage servicing rights capitalized and amortized for the years 2017, 2016 and 2015:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Balance, January 1	\$ 431	\$ 493	\$ 481
Servicing asset additions	83	74	144
Amortization	<u>(135)</u>	<u>(136)</u>	<u>(132)</u>
Balance, December 31	<u>\$ 379</u>	<u>\$ 431</u>	<u>\$ 493</u>

**NOTE 6 — PREMISES AND EQUIPMENT**

Premises and equipment at December 31, 2017 and 2016 is as follows:

*(Dollars in thousands)*

	Estimated Useful <u>Life (in years)</u>	<u>2017</u>	<u>2016</u>
Land	N/A	\$ 3,744	\$ 3,180
Buildings	5-40	20,562	19,519
Leasehold improvements	3-20	147	294
Equipment	3-25	<u>8,331</u>	<u>8,237</u>
		<u>32,784</u>	31,230
Less: Accumulated depreciation		<u>12,161</u>	<u>11,993</u>
Total		<u>\$ 20,623</u>	<u>\$ 19,237</u>

Depreciation amounted to \$1,197,000 for 2017, \$1,264,000 for 2016 and \$1,271,000 for 2015.

The banking subsidiary previously leased land and a bank building in Stroudsburg, Pennsylvania, under a lease that expired in the fourth quarter of 2017. At the time of lease expiration, the land and bank building were purchased for a total cost of \$2,384,000.

Included in buildings above is the bank building previously held under capital lease with a cost of \$948,000 at December 31, 2016, and accumulated amortization of \$904,000 at December 31, 2016. Amortization of the bank building previously held under the capital lease was \$43,000 for the year ended December 31, 2017, \$47,000 for the year ended December 31, 2016 and \$47,000 for the year ended December 31, 2015.

**NOTE 7 — CORE DEPOSIT INTANGIBLES**

Core deposit intangibles were comprised of the following at December 31, 2017 and 2016:

*(Dollars in thousands)*

	<u>Gross Carrying Amount</u>		<u>Accumulated Amortization</u>	
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Core deposit intangibles	<u>\$ 2,218</u>	<u>\$ 2,218</u>	<u>\$ 2,218</u>	<u>\$ 2,218</u>

Amortization expense of the core deposit intangibles was \$0, \$0 and \$122,000 for each the years ended December 31, 2017, 2016 and 2015, respectively. As of June 30, 2015, the core deposit intangible was fully amortized.

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**NOTE 8 — DEPOSITS**

Major classifications of deposits at December 31, 2017 and 2016 consisted of:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>
Non-interest bearing demand	\$ 121,415	\$ 110,314
Interest bearing demand	265,379	242,731
Savings	183,724	179,616
Time certificates of deposits less than \$250,000	171,556	164,515
Time certificates of deposits \$250,000 or greater	34,933	27,663
Other time	<u>1,139</u>	<u>1,143</u>
Total deposits	<u>\$ 778,146</u>	<u>\$ 725,982</u>

The following is a schedule reflecting classification and remaining maturities of time deposits at December 31, 2017:

*(Dollars in thousands)*

<u>Year Ending</u>	
2018	\$ 82,892
2019	55,678
2020	32,769
2021	14,788
2022	19,106
Thereafter	<u>2,395</u>
	<u>\$ 207,628</u>

At December 31, 2017, the largest two depositors had aggregate deposits of approximately \$138,245,000 as follows:

School district	\$ 122,077,000
School district	<u>16,168,000</u>
Total	<u>\$ 138,245,000</u>

**NOTE 9 — SHORT-TERM BORROWINGS**

Short-term borrowings include federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window, and Federal Home Loan Bank (“FHLB”) advances, which generally represent overnight or less than 30-day borrowings.

Short-term borrowings and weighted-average interest rates at and for the years ended December 31, 2017 and 2016 are as follows:

*(Dollars in thousands)*

	<u>2017</u>		<u>2016</u>	
	<u>Amount</u>	<u>Average Rate</u>	<u>Amount</u>	<u>Average Rate</u>
Federal funds purchased	\$ —	1.82%	\$ —	1.10%
Securities sold under agreements to repurchase	22,844	0.41%	18,490	0.26%
Federal Discount Window	—	1.71%	—	1.10%
Federal Home Loan Bank	<u>3,452</u>	1.16%	<u>50,800</u>	0.59%
	<u>\$ 26,296</u>	0.97%	<u>\$ 69,290</u>	0.48%

At December 31, 2017, the maximum borrowing capacity of federal funds purchased and the Federal Discount Window was \$15,000,000 and \$5,971,000, respectively. Please refer to Note 10 — Long-Term Borrowings for the Corporation’s maximum borrowing capacity at FHLB.

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**Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”)**

The Corporation enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Corporation may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Corporation to repurchase the assets.

As a result, these repurchase agreements are accounted for as collateralized financing agreements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability on the Corporation’s Consolidated Balance Sheets, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is not offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Corporation does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Corporation be in default (e.g., fails to make an interest payment to the counterparty). The collateral is held by a correspondent bank in the counterparty’s custodial account. The counterparty has the right to sell or repledge the investment securities.

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreements as of December 31, 2017 and 2016.

*(Dollars in thousands)*

	<b>Gross Amounts of Recognized Liabilities</b>	<b>Gross Amounts Offset in the Consolidated Balance Sheet</b>	<b>Net Amounts of Liabilities Presented in the Consolidated Balance Sheet</b>	<b>Financial Instruments</b>	<b>Cash Collateral Pledge</b>	<b>Net Amount</b>
<b>December 31, 2017</b>						
Repurchase agreements (a)	\$ 22,844	\$ —	\$ 22,844	\$ (22,844)	\$ —	\$ —
<b>December 31, 2016</b>						
Repurchase agreements (a)	\$ 18,490	\$ —	\$ 18,490	\$ (18,490)	\$ —	\$ —

(a) As of December 31, 2017 and 2016, the fair value of securities pledged in connection with repurchase agreements was \$26,023,000 and \$25,298,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of December 31, 2017.

*(Dollars in thousands)*

	<b>Remaining Contractual Maturity of the Agreements</b>				
	<b>Overnight and Continuous</b>	<b>Up to 30 days</b>	<b>30 -90 Days</b>	<b>Greater than 90 Days</b>	<b>Total</b>
Repurchase agreements and repurchase-to-maturity transactions:					
U.S. Treasury and/or agency securities	\$ 22,844	\$ —	\$ —	\$ —	\$ 22,844
Total	\$ 22,844	\$ —	\$ —	\$ —	\$ 22,844

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**NOTE 10 — LONG-TERM BORROWINGS**

Long-term borrowings are comprised of advances from FHLB. During the fourth quarter of 2017, the Bank purchased the Stroudsburg branch building which was previously under a long-term capital lease. After this purchase, the long-term capital lease balance was \$0 as of December 31, 2017 as compared to \$116,000 as of December 31, 2016.

Under terms of a blanket agreement, collateral for the FHLB loans is certain qualifying assets of the Corporation's banking subsidiary. The qualifying assets are real estate mortgages and certain investment securities.

A schedule of long-term borrowings by maturity as of December 31, 2017 and 2016 follows:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>
Due 2017, 1.07%	\$ —	\$ 10,000
Due 2018, 1.27% to 4.86%	<b>23,000</b>	23,000
Due 2019, 1.79% to 2.11%	<b>20,000</b>	20,000
Due 2020, 1.62% to 1.95%	<b>10,000</b>	10,000
Due 2021, 1.42% to 1.58%	<b>10,000</b>	10,000
Due 2028, 5.14%	<b>2,000</b>	2,000
	<b><u>\$ 65,000</u></b>	<b><u>\$ 75,000</u></b>

The Corporation's long-term borrowings consist of notes at fixed interest rates. Upon any default, under the terms of a master agreement, FHLB may declare all indebtedness of the Corporation immediately due. In addition, FHLB shall not be required to fund advances under any outstanding commitments. At December 31, 2017, the Corporation's maximum borrowing capacity at FHLB, which takes into account FHLB long-term notes and FHLB short-term borrowings, was \$299,115,000.

**NOTE 11 — INCOME TAXES**

The current and deferred components of the income tax expense consisted of the following:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Federal			
Current	<b>\$ 1,309</b>	\$ 2,135	\$ 1,688
Deferred	<b>146</b>	(290)	283
Income tax expense	<b><u>\$ 1,455</u></b>	<b><u>\$ 1,845</u></b>	<b><u>\$ 1,971</u></b>

The following is a reconciliation between the income tax expense and the amount of income taxes which would have been provided at the statutory rate of 34%:

*(Dollars in thousands)*

	<u>2017</u>		<u>2016</u>		<u>2015</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
Federal income tax at statutory rate	<b>\$ 3,435</b>	<b>34.0%</b>	\$ 3,848	34.0%	\$ 3,789	34.0%
Tax-exempt income	<b>(1,897)</b>	<b>(18.8)</b>	(1,555)	(13.7)	(1,374)	(12.3)
Low-income housing credits	<b>(323)</b>	<b>(3.2)</b>	(230)	(2.0)	(230)	(2.1)
Bank owned life insurance income	<b>(216)</b>	<b>(2.1)</b>	(377)	(3.3)	(226)	(2.0)
Effect of tax rate change	<b>379</b>	<b>3.8</b>	—	—	—	—
Other	<b>77</b>	<b>0.7</b>	159	1.3	12	0.1
Income tax expense and rate	<b><u>\$ 1,455</u></b>	<b><u>14.4%</u></b>	<b><u>\$ 1,845</u></b>	<b><u>16.3%</u></b>	<b><u>\$ 1,971</u></b>	<b><u>17.7%</u></b>

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The components of the net deferred tax asset at December 31, 2017 and 2016 are as follows:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>
Deferred Tax Assets:		
Allowance for loan losses	\$ 1,572	\$ 2,501
Provision for unfunded commitments	24	69
Deferred compensation	316	515
Contributions	8	16
Leases	66	168
Limited partnership investments	57	70
Alternative minimum tax credits	379	163
Net unrealized investment securities losses	—	648
Impairment loss on investment securities	4	6
Writedowns on OREO properties	5	—
Capital and net operating loss carry forwards	25	20
Total	<u>2,456</u>	<u>4,176</u>
Deferred Tax Liabilities:		
Net unrealized investment securities gains	670	—
Loan fees and costs	162	236
Accumulated depreciation	332	689
Accretion	77	121
Mortgage servicing rights	38	58
Intangibles	241	312
Total	<u>1,520</u>	<u>1,416</u>
Net Deferred Tax Asset	<u>\$ 936</u>	<u>\$ 2,760</u>

A valuation allowance for deferred tax assets was recorded at December 31, 2017 and 2016 in the amount of \$16,000. The valuation allowance relates to state net operating loss carryforwards for which realizability is uncertain. At December 31, 2017 and 2016, the Corporation had state net operating loss carryforwards of \$320,000 and \$297,000, respectively, which are available to offset future state taxable income, and expire at various dates through 2037.

In 2017, the Corporation recognized a reduction in the carrying value of the net deferred tax asset of \$379,000 as a result of the December 2017 enactment of a reduction in the federal corporate income tax rate to 21% effective January 1, 2018, from the 34% marginal tax rate in effect throughout 2017 and 2016. In 2017, the Corporation recognized a reduction in the carrying value of the net deferred tax asset of \$379,000 as a result of the December 2017 enactment of a reduction in the federal corporate income tax rate to 21% effective January 1, 2018, from the 34% marginal tax rate in effect throughout 2017 and 2016. On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (“SAB 118”) which provides guidance on accounting for the tax effects of the Tax Cuts and Job Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Cuts and Jobs Act’s enactment date for companies to complete the accounting under ASC 740, Income Taxes. The Corporation’s financial results reflect the income tax effects of the Tax Cuts and Jobs Act for which the accounting under ASC Topic 740 is complete.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible and tax planning strategies, management believes it is more likely than not that the Corporation will realize the benefits of these deferred tax assets, net of any valuation allowance at December 31, 2017.

The Corporation did not have any uncertain tax positions at December 31, 2017 and 2016.

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The Corporation and its subsidiary file a consolidated federal income tax return. The Corporation is no longer subject to examination by Federal or State taxing authorities for the years before 2014.

**NOTE 12 — EMPLOYEE BENEFIT PLANS AND DEFERRED COMPENSATION AGREEMENTS**

The Corporation maintains a 401k Plan which has a combined tax qualified savings feature and profit sharing feature for the benefit of its employees. Effective January 1, 2014, the plan became a Safe Harbor Plan. Under the savings feature, the Corporation makes safe harbor matching contributions of 100% of the first 3% of compensation an employee contributes to the Plan and 50% of the next 2% of compensation an employee contributes to the Plan. The safe harbor matching contributions amounted to \$274,000, \$264,000 and \$281,000 in 2017, 2016 and 2015, respectively. Under the profit sharing feature, contributions, at the discretion of the Board of Directors, are funded currently and amounted to \$215,000, \$346,000 and \$297,000 in 2017, 2016 and 2015, respectively.

The Bank also has non-qualified deferred compensation agreements with two of its officers and five retired officers. These agreements are essentially unsecured promises by the Bank to make monthly payments to the officers over a twenty year period. Payments begin based upon specific criteria — generally, when the officer retires. To account for the cost of payments yet to be made in the future, the Bank recognizes an accrued liability in years prior to when payments begin based on the present value of those future payments. The Bank’s accrued liability for these deferred compensation agreements, reported in other liabilities on the consolidated balance sheets, as of December 31, 2017 and 2016, was \$1,464,000 and \$1,474,000, respectively. The related expense for these agreements, reported in salaries and employee benefits on the consolidated statements of income, amounted to \$117,000, \$117,000 and \$82,000 in 2017, 2016 and 2015, respectively.

**NOTE 13 — COMMITMENTS AND CONTINGENCIES**

The Corporation’s banking subsidiary currently leases three branch banking facilities and one parcel of land under operating leases. Rent expense for the years ended December 31, 2017, 2016 and 2015 was \$155,000, \$154,000 and \$153,000, respectively. Minimum rental payments required under these operating leases are: 2018 - \$134,000, 2019 - \$110,000, 2020 - \$59,000, 2021 - \$59,000, 2022 - \$68,000 and thereafter \$2,462,000.

In the normal course of business, there are various pending legal actions and proceedings that are not reflected in the consolidated financial statements. Management does not believe the outcome of these actions and proceedings will have a material effect on the consolidated financial position of the Corporation.

**NOTE 14 — RELATED PARTY TRANSACTIONS**

Certain directors and executive officers of First Keystone Corporation and its subsidiary and companies in which they are principal owners (i.e., at least 10% ownership) were indebted to the Corporation at December 31, 2017 and 2016. The loans do not involve more than the normal risk of collectability nor present other unfavorable features.

A summary of the activity on the related party loans, comprised of directors and executive officers and their related companies consists of the following:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>
Balance at January 1	\$ 2,159	\$ 3,678
Additions	15,574	701
Deductions	<u>(6,736)</u>	<u>(2,220)</u>
Balance at December 31	<u>\$10,997</u>	<u>\$ 2,159</u>

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The summary of activity on the related party loans on page 85 represent funds drawn and outstanding at the date of the consolidated financial statements. Commitments by the Bank to related parties on lines of credit and letters of credit for 2017 and 2016, presented an additional off-balance sheet risk to the extent of undisbursed funds in the amounts of \$6,214,000 and \$7,907,000 respectively, on the above loans.

Deposits from certain officers and directors and/or their related companies held by the Bank amounted to \$15,180,000 and \$9,005,000 at December 31, 2017 and 2016, respectively.

**NOTE 15 — REGULATORY MATTERS**

Under Pennsylvania banking law, the Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2017, \$8,627,000 of retained earnings were available for dividends without prior regulatory approval, subject to the regulatory capital requirements discussed below. Regulations also limit the amount of loans and advances from the Bank to the Corporation to 10% of consolidated net assets.

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory — and possibly additional discretionary — actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Management believes, as of December 31, 2017 and 2016, that the Corporation and the Bank met all capital adequacy requirements to which they are subject.

On July 2, 2013, the Board of Governors of the Federal Reserve System finalized its rule implementing the Basel III regulatory capital framework, which the FDIC adopted on July 9, 2013. Under the rule, minimum requirements increased both the quantity and quality of capital held by banking organizations. Consistent with the Basel III framework, the rule included a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5 percent, and a common equity tier 1 conservation buffer of 2.5 percent of risk-weighted assets, that applies to all supervised financial institutions, which is to be phased in over a four year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019. The rule also raised the minimum ratio of tier 1 capital to risk-weighted assets from 4 percent to 6 percent, and includes a minimum leverage ratio of 4 percent for all banking organizations.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total capital, tier I capital and common equity tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of tier I capital (as defined) to average assets (as defined).



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As of December 31, 2017, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as Well Capitalized under the regulatory framework for prompt corrective action. To be categorized as Well Capitalized, the Bank must maintain minimum total risk-based, tier I risk-based, common equity tier 1 risk-based and tier I leverage ratios as set forth in the table. There are no conditions or events since the notification that management believes have changed the Bank's category.

*(Dollars in thousands)*

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>Minimum Capital Adequacy with Capital Buffer</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	<b>As of December 31, 2017:</b>							
Total Capital (to Risk-Weighted Assets)	\$93,566	14.21%	\$52,676	8.00%	\$60,907	9.25%	\$65,845	10.00%
Tier I Capital (to Risk-Weighted Assets)	\$85,963	13.06%	\$39,507	6.00%	\$47,738	7.25%	\$52,676	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$85,963	13.06%	\$29,630	4.50%	\$37,861	5.75%	\$42,800	6.50%
Tier I Capital (to Average Assets)	\$85,963	8.84%	\$38,901	4.00%	\$38,901	4.00%	\$48,626	5.00%

*(Dollars in thousands)*

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>Minimum Capital Adequacy with Capital Buffer</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	<b>As of December 31, 2016:</b>							
Total Capital (to Risk-Weighted Assets)	\$91,371	14.24%	\$51,344	8.00%	\$55,355	8.625%	\$64,180	10.00%
Tier I Capital (to Risk-Weighted Assets)	\$83,812	13.06%	\$38,508	6.00%	\$42,519	6.625%	\$51,344	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$83,812	13.06%	\$28,881	4.50%	\$32,894	5.125%	\$41,717	6.50%
Tier I Capital (to Average Assets)	\$83,812	8.67%	\$38,669	4.00%	\$38,669	4.000%	\$48,336	5.00%

The capital conservation buffer phase-in began January 1, 2016. The capital conservation buffer increased from 0.625% in 2016 to 1.250% in 2017.

The Corporation's capital ratios are not materially different from those of the Bank.

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**NOTE 16 — FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS OF CREDIT RISK**

**Financial Instruments with Off Balance Sheet Risk**

The Corporation 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 include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

The Corporation's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The Corporation may require collateral or other security to support financial instruments with off-balance sheet credit risk.

The contract or notional amounts at December 31, 2017 and 2016 were as follows:

*(Dollars in thousands)*

	<u>2017</u>	<u>2016</u>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 90,373	\$ 84,519
Financial standby letters of credit	\$ 450	\$ 453
Performance standby letters of credit	\$ 2,901	\$ 5,341

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses that may require payment of a fee. Since some of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, owner-occupied income-producing commercial properties, and residential real estate.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee payment to a third party when a customer either fails to repay an obligation or fails to perform some non-financial obligation. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation may hold collateral (similar to the items held as collateral for commitments to extend credit) to support standby letters of credit for which collateral is deemed necessary.

**Financial Instruments with Concentrations of Credit Risk**

The Corporation originates primarily commercial and residential real estate loans to customers in northeastern Pennsylvania. The ability of the majority of the Corporation's customers to honor their contractual loan obligations is dependent on the economy and real estate market in this area. At December 31, 2017, the Corporation had \$453,895,000 in loans secured by real estate, which represented 81.1% of total loans. The real estate loan portfolio is largely secured by lessors of residential buildings and dwellings, lessors of non-residential buildings, and lessors of hotels/motels. As of December 31, 2017 and 2016, management is of the opinion that there were no concentrations exceeding 10% of total loans with regard to loans to borrowers who were engaged in similar activities that were similarly impacted by economic or other conditions.

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As all financial instruments are subject to some level of credit risk, the Corporation requires collateral and/or guarantees for all loans. Collateral may include, but is not limited to property, plant, and equipment, commercial and/or residential real estate property, land, and pledge of securities. In the event of a borrower's default, the collateral supporting the loan may be seized in order to recoup losses associated with the loan. The Corporation also establishes an allowance for loan losses that constitutes the amount available to absorb losses within the loan portfolio that may exist due to deficiencies in collateral values.

**NOTE 17 — STOCKHOLDERS' EQUITY**

The Corporation also offers to its shareholders a Dividend Reinvestment and Stock Purchase Plan. Participation in this plan by shareholders began in 2001. The plan provides First Keystone shareholders a convenient and economical way to purchase additional shares of common stock by reinvesting dividends. A plan participant can elect full dividend reinvestment or partial dividend reinvestment provided at least 25 shares are enrolled in the plan. In addition, plan participants may make additional voluntary cash purchases of common stock under the plan of not less than \$100 per calendar quarter or more than \$2,500 in any calendar quarter.

Shares transferred under this Dividend Reinvestment and Stock Purchase Plan were 46,388 in 2017, 51,246 in 2016 and 50,796 in 2015. Remaining shares authorized in the plan were 17,420 as of December 31, 2017.

Shares of First Keystone common stock are purchased for the plan either in the open market by an independent broker on behalf of the plan, directly from First Keystone as original issue shares, or through negotiated transactions. A combination of the previous methods could also occur.

**NOTE 18 — STOCK COMPENSATION PLAN**

On February 10, 1998, the Board of Directors adopted the 1998 Employee Stock Option Plan and initially reserved 100,000 shares of common stock for issuance under the plan for certain employees of the Bank. After adjustments for the effects of stock dividends, options exercised and options forfeited, there are no exercisable options issued and outstanding. Under the Plan, options are granted at fair market value and the time period during which any option granted may be exercised may not commence before six months or continue beyond the expiration of ten years after the option is awarded. Upon exercise of the stock options, shares of the Corporation's stock are issued from Treasury Stock. The Plan expired in 2008, and therefore, no stock options are available for issuance.

The fair value of stock options issued to employees is measured on the date of the grant and is recognized as compensation expense over the requisite service period. Expected volatility and dividend yield are based on historical stock prices and dividend amounts over past time periods equal in length to the life of the options. The risk-free interest rate is determined using the U.S. Treasury yield curve in effect at the date of the grant. The expected life of the options is calculated using the average term of the vesting period and the maximum term.

Information about stock options outstanding at December 31, 2017, 2016 and 2015, is summarized as follows:

	<u>2017</u>		<u>2016</u>		<u>2015</u>	
	<b>Stock</b>	<b>Weighted Average Exercise Price</b>	<b>Stock</b>	<b>Weighted Average Exercise Price</b>	<b>Stock</b>	<b>Weighted Average Exercise Price</b>
	<b>Options</b>	<b>Price</b>	<b>Options</b>	<b>Price</b>	<b>Options</b>	<b>Price</b>
Balance at January 1	1,500	\$16.75	1,500	\$16.75	4,323	\$18.28
Exercised	(1,500)	16.75	—	—	(2,037)	18.37
Forfeited/Expired	—	—	—	—	(786)	20.95
Balance at December 31	<u>—</u>	<u>—</u>	<u>1,500</u>	<u>\$16.75</u>	<u>1,500</u>	<u>\$16.75</u>
Exercisable at December 31	<u>—</u>	<u>—</u>	<u>1,500</u>	<u>\$16.75</u>	<u>1,500</u>	<u>\$16.75</u>

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Under the terms of the Plan, the stock options including amendments as to price and terms were adjusted for the stock dividend in 2006.

The total intrinsic value of the options exercised during the years ended December 31, 2017, 2016 and 2015 was \$18,000, \$0, and \$16,000, respectively. Cash received from stock options exercised for the years ended December 31, 2017, 2016 and 2015 was \$25,000, \$0, and \$37,000, respectively.

**NOTE 19 — FAIR VALUE MEASUREMENTS**

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. This guidance provides additional information on determining when the volume and level of activity for the asset or liability has significantly decreased. The guidance also includes information on identifying circumstances when a transaction may not be considered orderly.

Fair value measurement and disclosure guidance provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with the fair value measurement and disclosure guidance.

This guidance clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The guidance provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own belief about the assumptions market participants would use in pricing the asset or liability based upon the best information available in the circumstances. Fair value measurement and disclosure guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 Inputs: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 Inputs: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth as follows.

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**Financial Assets Measured at Fair Value on a Recurring Basis**

At December 31, 2017 and 2016, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

*(Dollars in thousands)*

<b>December 31, 2017</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Available-for-Sale Securities:				
U.S. Treasury securities	\$ —	\$ —	\$ —	\$ —
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	—	81,860	—	81,860
Other	—	22,233	—	22,233
Obligations of state and political subdivisions	—	215,522	—	215,522
Corporate debt securities	—	28,971	—	28,971
Marketable equity securities	<u>1,632</u>	—	—	<u>1,632</u>
Total	<u>\$ 1,632</u>	<u>\$ 348,586</u>	<u>\$ —</u>	<u>\$ 350,218</u>

*(Dollars in thousands)*

December 31, 2016	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
U.S. Treasury securities	\$ —	\$ 1,010	\$ —	\$ 1,010
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	—	110,907	—	110,907
Other	—	20,970	—	20,970
Obligations of state and political subdivisions	—	211,134	—	211,134
Corporate debt securities	—	33,976	—	33,976
Marketable equity securities	<u>1,640</u>	—	—	<u>1,640</u>
Total	<u>\$ 1,640</u>	<u>\$ 377,997</u>	<u>\$ —</u>	<u>\$ 379,637</u>

The estimated fair values of equity securities classified as Level 1 are derived from quoted market prices in active markets; these assets consist mainly of stocks held in other banks. The estimated fair values of all debt securities classified as Level 2 are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Corporation (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy. The Corporation does not have any Level 3 inputs for investments. There were no transfers between Level 1 and Level 2 during 2017 and 2016.

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

At December 31, 2017 and 2016, impaired loans measured at fair value on a nonrecurring basis and the valuation methods used are as follows:

*(Dollars in thousands)*

<b>Assets at December 31, 2017</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Impaired loans:				
Commercial Real Estate	\$ —	\$ —	\$ 5,498	\$ 5,498
Residential Real Estate	—	—	254	254
Total impaired loans	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,752</u>	<u>\$ 5,752</u>

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*(Dollars in thousands)*

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2016				
Impaired loans:				
Commercial Real Estate	\$ —	\$ —	\$ 4,763	\$ 4,763
Residential Real Estate	<u>—</u>	<u>—</u>	<u>524</u>	<u>524</u>
Total impaired loans	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,287</u>	<u>\$ 5,287</u>

The Bank's impaired loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values. For impaired loans less than \$250,000 upon classification and annually at year end, the Bank completes a Certificate of Inspection, which includes an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. The fair value consists of the impaired loan balances less the valuation allowance and/or charge-offs. There were no transfers between valuation levels in 2017 and 2016.

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

At December 31, 2017 and 2016, foreclosed assets held for resale measured at fair value on a nonrecurring basis and the valuation methods used are as follows:

*(Dollars in thousands)*

	Level 1	Level 2	Level 3	Total
<b>Assets at December 31, 2017</b>				
Other foreclosed assets held for resale:				
Commercial Real Estate	\$ —	\$ —	\$ 81	\$ 81
Residential Real Estate	<u>—</u>	<u>—</u>	<u>13</u>	<u>13</u>
Total foreclosed assets held for resale	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 94</u>	<u>\$ 94</u>

*(Dollars in thousands)*

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2016				
Other foreclosed assets held for resale:				
Commercial Real Estate	\$ —	\$ —	\$ 248	\$ 248
Residential Real Estate	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Total foreclosed assets held for resale	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 248</u>	<u>\$ 248</u>

The Bank's foreclosed asset valuation procedure requires an appraisal, which considers the sales prices of similar properties in the proximate vicinity, to be completed periodically with the exception of those cases in which the Bank has obtained a sales agreement. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2017 and 2016.

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**Notes to Consolidated Financial Statements**

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

(Dollars in thousands)

	Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value Estimate	Valuation Technique	Unobservable Input	Range	Weighted Average
<b>December 31, 2017</b>					
Impaired loans	\$ 2,495	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(7%) – (65%)	(15%)
Impaired loans	\$ 3,257	Discounted cash flow	Discount rate	(7%) – (8%)	(7%)
Foreclosed assets held for sale	\$ 94	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(35%) – (37%)	(36%)
<b>December 31, 2016</b>					
Impaired loans	\$ 2,119	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(10%) – (79%)	(21%)
Impaired loans	\$ 3,168	Discounted cash flow	Discount rate	(7%) – (7%)	(7%)
Foreclosed assets held for sale	\$ 248	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(23%) – (37%)	(32%)

<sup>1</sup>Fair value is generally determined through independent appraisals of the underlying collateral, as defined by Bank regulators.

<sup>2</sup>Appraisals may be adjusted downward by management for qualitative factors such as economic conditions and estimated liquidation expenses. The typical range of appraisal adjustments are presented as a percent of the appraisal value.

<sup>3</sup>Includes qualitative adjustments by management and estimated liquidation expenses.

**Fair Value of Financial Instruments**

(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at December 31, 2017			
		Level 1	Level 2	Level 3	Total
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$ 7,913	\$ 7,913	\$ —	\$ —	\$ 7,913
Interest-bearing deposits in other banks	826	—	826	—	826
Time deposits with other banks	1,482	—	1,482	—	1,482
Investment securities available-for-sale	350,218	1,632	348,586	—	350,218
Investment securities held-to-maturity	—	—	—	—	—
Restricted investment in bank stocks	4,058	—	4,058	—	4,058
Net loans	551,910	—	—	550,696	550,696
Mortgage servicing rights	379	—	—	379	379
Accrued interest receivable	4,237	—	4,237	—	4,237
<b>FINANCIAL LIABILITIES:</b>					
Deposits	778,146	—	776,817	—	776,817
Short-term borrowings	26,296	—	26,296	—	26,296
Long-term borrowings	65,000	—	65,336	—	65,336
Accrued interest payable	490	—	490	—	490
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS</b>					
	—	—	—	—	—

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**Notes to Consolidated Financial Statements**

<i>(Dollars in thousands)</i>	Carrying <u>Amount</u>	Fair Value Measurements at December 31, 2016			
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$ 8,338	\$ 8,338	\$ —	\$ —	\$ 8,338
Interest-bearing deposits in other banks	790	—	790	—	790
Time deposits with other banks	1,482	—	1,482	—	1,482
Investment securities available-for-sale	379,637	1,640	377,997	—	379,637
Investment securities held-to-maturity	4	—	4	—	4
Restricted investment in bank stocks	5,477	—	5,477	—	5,477
Net loans	515,025	—	—	504,206	504,206
Mortgage servicing rights	431	—	—	431	431
Accrued interest receivable	3,917	—	3,917	—	3,917
<b>FINANCIAL LIABILITIES:</b>					
Deposits	725,982	—	725,473	—	725,473
Short-term borrowings	69,290	—	69,290	—	69,290
Long-term borrowings	75,116	—	75,718	—	75,718
Accrued interest payable	427	—	427	—	427
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS</b>					
	—	—	—	—	—

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at December 31, 2017 and December 31, 2016:

**Cash and Due From Banks, Interest-Bearing Deposits in Other Banks, Time Deposits with Other Banks, Restricted Investment in Bank Stocks, Accrued Interest Receivable and Accrued Interest Payable**

The fair values are equal to the current carrying values.

**Investment Securities**

The fair value of investment securities are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1) or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying on the securities' relationship to other benchmark quoted prices.

**Loans**

Fair values are estimated for categories of loans with similar financial characteristics. Loans were segregated by type such as Commercial and Industrial, Commercial and Residential Real Estate mortgages and Consumer. For estimation purposes, each loan category was further segmented into fixed and adjustable rate interest terms.

The fair value of each category of performing loans is calculated by discounting future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Fair value for impaired loans is based on management's estimate of future cash flows discounted using a rate commensurate with the risk associated with the estimated future cash flows or based on the value of the collateral if repayment is expected solely from collateral. The assumptions used by management are judgmentally determined using information regarding each specific borrower.



**Mortgage Servicing Rights**

Servicing rights are carried at cost. The carrying amount approximates fair value.

**Deposits**

The fair value of deposits with no stated maturity, such as demand deposits, savings accounts and money market accounts, is equal to the amount payable on demand at December 31, 2017 and 2016.

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar term borrowings, to a schedule of aggregated expected monthly maturities on time deposits.

**Short-Term and Long-Term Borrowings**

The fair values of short-term borrowings are equal to the current carrying values, and long-term borrowings are estimated using discounted cash flow analyses based on the Corporation's incremental borrowing rate for similar instruments.

**Off-Balance Sheet Financial Instruments**

The fair values for the Corporation's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**Notes to Consolidated Financial Statements**

**NOTE 20 — PARENT COMPANY FINANCIAL INFORMATION**

Condensed financial information for First Keystone Corporation (parent company only) was as follows:

**BALANCE SHEETS**

*(Dollars in thousands)*

	December 31,	
	<u>2017</u>	<u>2016</u>
<b>ASSETS</b>		
Cash	\$ 8,984	\$ 7,660
Investment in banking subsidiary	106,647	101,033
Investment securities available-for-sale	1,632	1,640
Prepaid expenses and other assets	<u>30</u>	<u>12</u>
TOTAL ASSETS	<u>\$117,293</u>	<u>\$110,345</u>
<b>LIABILITIES</b>		
Advances from banking subsidiary	\$ 325	\$ 109
Accrued expenses and other liabilities	<u>249</u>	<u>551</u>
TOTAL LIABILITIES	<u>574</u>	<u>660</u>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock	11,902	11,809
Surplus	36,193	35,047
Retained earnings	72,507	70,004
Accumulated other comprehensive income (loss)	1,826	(1,419)
Treasury stock, at cost	<u>(5,709)</u>	<u>(5,756)</u>
TOTAL STOCKHOLDERS' EQUITY	<u>116,719</u>	<u>109,685</u>
 TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	 <u>\$117,293</u>	 <u>\$110,345</u>

**STATEMENTS OF INCOME**

*(Dollars in thousands)*

	Years Ended December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
<b>INCOME</b>			
Dividends from subsidiary bank	\$ 6,102	\$ 6,102	\$ 6,102
Net investment securities gains	74	368	—
Other income	<u>73</u>	<u>84</u>	<u>79</u>
TOTAL INCOME	6,249	6,554	6,181
 OPERATING EXPENSES	 <u>117</u>	 <u>110</u>	 <u>133</u>
 INCOME TAX (BENEFIT) EXPENSE	 <u>6,132</u>	 <u>6,444</u>	 <u>6,048</u>
	<u>(110)</u>	<u>101</u>	<u>(33)</u>
	6,242	6,343	6,081
 EQUITY IN UNDISTRIBUTED EARNINGS OF BANKING SUBSIDIARY	 <u>2,406</u>	 <u>3,129</u>	 <u>3,091</u>
 NET INCOME	 <u>\$ 8,648</u>	 <u>\$ 9,472</u>	 <u>\$ 9,172</u>

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY**  
**Notes to Consolidated Financial Statements**

**STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(Dollars in thousands)

	Years Ended December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
Net Income	<u>\$ 8,648</u>	<u>\$ 9,472</u>	<u>\$ 9,172</u>
Other comprehensive income (loss):			
Unrealized net holding gains (losses) on available-for-sale investment securities arising during the period, net of income taxes of \$55, \$156 and \$(19), respectively	81	229	(29)
Less reclassification adjustment for net gains included in net income, net of income taxes of \$(30), \$(149) and \$0, respectively	(44)	(219)	—
Less reclassification adjustment for impairment charges on equity securities included in net income, net of income taxes of \$0, \$5 and \$0, respectively	—	—	9
Equity in other comprehensive income (loss) of banking subsidiary	<u>3,208</u>	<u>(3,464)</u>	<u>(2,275)</u>
Total other comprehensive income (loss)	<u>3,245</u>	<u>(3,454)</u>	<u>(2,295)</u>
Total Comprehensive Income (Loss)	<u>\$ 11,893</u>	<u>\$ 6,018</u>	<u>\$ 6,877</u>

**STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

	Years Ended December 31,		
	<u>2017</u>	<u>2016</u>	<u>2015</u>
<b>OPERATING ACTIVITIES</b>			
Net income	\$ 8,648	\$ 9,472	\$ 9,172
Adjustments to reconcile net income to net cash provided by operating activities:			
Gains on sales of investment securities	(74)	(368)	—
Impairment charges on equity securities	—	—	14
Deferred income tax (benefit) expense	(110)	15	63
Equity in undistributed earnings of banking subsidiary	(2,406)	(3,129)	(3,091)
(Increase) decrease in prepaid/accrued expenses and other assets/liabilities	(235)	1,267	(1,095)
Increase (decrease) in advances from banking subsidiary	<u>216</u>	<u>(1,126)</u>	<u>1,017</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>6,039</u>	<u>6,131</u>	<u>6,080</u>
<b>INVESTING ACTIVITIES</b>			
Proceeds from sales of investment securities available-for-sale	<u>144</u>	<u>752</u>	<u>—</u>
NET CASH PROVIDED BY INVESTING ACTIVITIES	<u>144</u>	<u>752</u>	<u>—</u>
<b>FINANCING ACTIVITIES</b>			
Proceeds from issuance of common stock	1,261	1,319	1,252
Proceeds from exercise of stock options	25	—	37
Dividends paid	<u>(6,145)</u>	<u>(6,090)</u>	<u>(6,035)</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>(4,859)</u>	<u>(4,771)</u>	<u>(4,746)</u>
INCREASE IN CASH AND CASH EQUIVALENTS	1,324	2,112	1,334
CASH AND CASH EQUIVALENTS, BEGINNING	<u>7,660</u>	<u>5,548</u>	<u>4,214</u>
CASH AND CASH EQUIVALENTS, ENDING	<u>\$ 8,984</u>	<u>\$ 7,660</u>	<u>\$ 5,548</u>

## **Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders  
First Keystone Corporation  
Berwick, Pennsylvania

### **Opinion on Internal Control over Financial Reporting**

We have audited First Keystone Corporation and its Subsidiary (the “Corporation’s”) internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the “COSO” criteria). In our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the consolidated balance sheets of the Corporation as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2017, and the related notes and our report dated March 16, 2018, expressed an unqualified opinion thereon.

### **Basis for Opinion**

The Corporation’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, “Management’s Report on Internal Control over Financial Reporting”. Our responsibility is to express an opinion on the Corporation’s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Corporation in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit of internal control over financial reporting in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

### **Definition and Limitations of Internal Control over Financial Reporting**

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ BDO USA, LLP

Harrisburg, Pennsylvania  
March 16, 2018

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

**Evaluation of Disclosure Controls and Procedures**

First Keystone Corporation maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the Chief Executive Officer and Chief Financial Officer of the Corporation concluded that the Corporation's disclosure controls and procedures were effective as of December 31, 2017.

**Management's Report on Internal Control Over Financial Reporting**

The management of First Keystone Corporation is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities and Exchange Act of 1934). The Corporation's internal control system was designed to provide reasonable assurance to the Corporation's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

The management of First Keystone Corporation, along with participation of the Chief Executive Officer and the Chief Financial Officer, assessed the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2017. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the *Internal Control — Integrated Framework (2013)*. Based on our assessment we believe that, as of December 31, 2017, the Corporation's internal control over financial reporting is effective based on those criteria.

First Keystone Corporation's independent registered public accounting firm that audited the consolidated financial statements has issued an audit report on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2017. This report can be found in Item 8 of this Form 10-K.

Item 9A of the Corporation's Annual Report on Form 10-K for the fiscal year ended December 31, 2016, stated that management's review of the Corporation's internal control over financial reporting identified certain deficiencies which, in the aggregate, constituted a material weakness at December 31, 2016, and described the Corporation's remediation plan to address such deficiencies. An internal control material weakness is a significant deficiency, or combination of significant deficiencies, in internal control over financial reporting, such that there is reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. The Corporation's remediation efforts included enhancements to the review of specific reserves on impaired loans to ensure a review is being performed at an appropriate level of precision to include expanded validation of inputs and assumptions to source documents and ensuring clerical accuracy. During the quarter ended March 31, 2017, the Corporation commenced the remediation efforts described in Item 9A of the fiscal 2016 Annual Report on Form 10-K and such efforts continued through the quarter ended December 31, 2017. As indicated above, after completing its assessment of the Corporation's internal control over financial reporting as of December 31, 2017, management concluded that the Corporation had remediated the previously identified weakness.

**Changes in Internal Control over Financial Reporting**

Other than the changes described above, there were no changes in the Corporation's internal control over financial reporting during the fiscal quarter ended December 31, 2017, that materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

There was no information required on Form 8-K during this quarter that was not reported.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information under the captions “Information As To Directors and Nominees,” “Principal Officers of the Bank and the Corporation,” “Committees of the Board of Directors” and “Section 16(A) Beneficial Ownership Reporting Compliance” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

CODE OF ETHICS

The Corporation has adopted a Directors and Senior Management Code of Ethics, which applies to all members of the Board of Directors and to senior officers of the Corporation. It can be found on the Investor Relations section of our website at [www.firstkeystonecorporation.com](http://www.firstkeystonecorporation.com).

ITEM 11. EXECUTIVE COMPENSATION

The information under the captions “Executive Compensation”, “Compensation Discussion and Analysis (CD&A)”, “Compensation Committee Interlocks and Insider Participation”, and “Compensation Committee Report” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information under the caption “Share Ownership” is incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans excluding securities reflected in column (a) (c)
Equity compensation plans approved by shareholders	—	\$ —	—
Equity compensation plans not approved by shareholders	—	—	—
Total	—	\$ —	—

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information under the captions “Related Person Transactions” and “Governance of the Company” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information under the captions “Report of the Audit Committee” and “Proposal No. 2: Ratification of Independent Registered Public Accounting Firm” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1. Financial Statements

The following consolidated financial statements are included in Part II, Item 8, of this Report:

First Keystone Corporation and Subsidiary.

Reports of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets  
Consolidated Statements of Income  
Consolidated Statements of Comprehensive Income  
Consolidated Statements of Changes in Stockholders’ Equity  
Consolidated Statements of Cash Flows  
Notes to Consolidated Financial Statements

2. Financial Statement Schedules

Financial statements schedules are omitted because the required information is either not applicable, not required, or is shown in the financial statements or in their notes.

ITEM 16. FORM 10-K SUMMARY

None.

### 3. Exhibits

Exhibits required by Item 601 of Regulation S-K:

<u>Exhibit Number Referred to Item 601 of Regulation S-K</u>	<u>Description of Exhibit</u>
3i	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10-Q for the quarter ended June 30, 2012).
3ii	By-Laws, as amended and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated February 14, 2013).
10.1(a)	Supplemental Employee Retirement Plan – J. Gerald Bazewicz (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*
10.1(b)	Supplemental Employee Retirement Plan – David R. Saracino (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*
10.1(c)	Supplemental Employee Retirement Plan – Matthew P. Prosseda (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*
10.1(d)	Supplemental Employee Retirement Plan – Elaine Woodland (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*
10.2	Management Incentive Compensation Plan (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*
10.4	First Keystone Corporation 1998 Stock Incentive Plan (Incorporated by reference to Exhibit 10 to Registrant's Report on Form 10-Q for the quarter ended September 30, 2006).*
14	First Keystone Corporation Directors and Senior Management Code of Ethics (Incorporated by reference to Exhibit 99.1 to Registrant's Report on Form 8-K dated August 27, 2013).
21	List of Subsidiaries of the Issuer, filed with this annual report on Form 10-K.**
23.1	Consent of BDO USA, LLP.**
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.**
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.**
32.1	Section 1350 Certification of Chief Executive Officer.**
32.2	Section 1350 Certification of Chief Financial Officer.**
101.INS	XBRL Instance Document.**
101.SCH	XBRL Taxonomy Extension Schema Document.**
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.**
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.**
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.**
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.**

\* Denotes a compensatory plan.

\*\* Filed herewith.

The Corporation will provide a copy of any exhibit upon receipt of a written request for the particular exhibit or exhibits desired. All requests should be addressed to the Corporation's principal executive offices.



## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

### FIRST KEYSTONE CORPORATION

/s/ Matthew P. Prosseda

Matthew P. Prosseda  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: March 16, 2018

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>/s/ John E. Arndt</u> John E. Arndt, Vice Chairman/Director	<u>March 16, 2018</u> Date
<u>/s/ Don E. Bower</u> Don E. Bower, Director	<u>March 16, 2018</u> Date
<u>/s/ Robert A. Bull</u> Robert A. Bull, Chairman/Director	<u>March 16, 2018</u> Date
<u>/s/ Robert E. Bull</u> Robert E. Bull, Director	<u>March 16, 2018</u> Date
<u>/s/ Joseph B. Conahan, Jr.</u> Joseph B. Conahan, Jr., Director	<u>March 16, 2018</u> Date
<u>/s/ Jerome F. Fabian</u> Jerome F. Fabian, Director	<u>March 16, 2018</u> Date
<u>/s/ John G. Gerlach</u> John G. Gerlach, Director	<u>March 16, 2018</u> Date
<u>/s/ Nancy J. Marr</u> Nancy J. Marr, Director	<u>March 16, 2018</u> Date
<u>/s/ Matthew P. Prosseda</u> Matthew P. Prosseda, President/ Chief Executive Officer/Director	<u>March 16, 2018</u> Date
<u>/s/ Diane C.A. Rosler</u> Diane C.A. Rosler, Chief Financial Officer (Principal Financial Officer)	<u>March 16, 2018</u> Date
<u>/s/ David R. Saracino</u> David R. Saracino, Secretary/Director	<u>March 16, 2018</u> Date

FIRST KEYSTONE CORPORATION  
LIST OF SUBSIDIARIES OF THE ISSUER

Direct Subsidiary: First Keystone Community Bank, Pennsylvania state chartered commercial bank.

The consolidated financial statements include the accounts of the Corporation and its subsidiary.

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

First Keystone Corporation  
Berwick, Pennsylvania

We hereby consent to the incorporation by reference in the Registration Statement on Form S-3D (No. 333-145093) of First Keystone Corporation of our reports dated March 16, 2018, relating to the consolidated financial statements, and the effectiveness of internal control over financial reporting of First Keystone Corporation, which appear in this Form 10-K.

/s/ BDO USA, LLP  
Harrisburg, Pennsylvania

March 16, 2018

**FIRST KEYSTONE CORPORATION  
CERTIFICATION**

I, Matthew P. Prosseda, certify that:

1. I have reviewed this annual report on Form 10-K for the period ended December 31, 2017, of First Keystone Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Matthew P. Prosseda  
Matthew P. Prosseda  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: March 16, 2018

**FIRST KEYSTONE CORPORATION  
CERTIFICATION**

I, Diane C.A. Rosler, certify that:

1. I have reviewed this annual report on Form 10-K for the period ended December 31, 2017, of First Keystone Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Diane C.A. Rosler \_\_\_\_\_  
Diane C.A. Rosler  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

Date: March 16, 2018

FIRST KEYSTONE CORPORATION  
CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of First Keystone Corporation (the "Corporation") for the period ended December 31, 2017, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Matthew P. Prosseda, President and Chief Executive Officer, certify, pursuant to and for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation as of and for the period covered by the Report.

/s/ Matthew P. Prosseda  
Matthew P. Prosseda  
President and Chief Executive Officer  
(Principal Executive Officer)

March 16, 2018

A signed original of this written statement required by Section 906 has been provided to the Corporation and will be retained by the Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

FIRST KEYSTONE CORPORATION  
CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of First Keystone Corporation (the "Corporation") for the period ended December 31, 2017, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Diane C.A. Rosler, Chief Financial Officer, certify, pursuant to and for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation as of and for the period covered by the Report.

/s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

March 16, 2018

A signed original of this written statement required by Section 906 has been provided to the Corporation and will be retained by the Corporation and furnished to the Securities and Exchange Commission or its staff upon request.