ACNB CORP
Form 10-Q
November 03, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2017

Commission file number 1-35015

ACNB CORPORATION

(Exact name of Registrant as specified in its charter)

Pennsylvania (State or other jurisdiction of incorporation or organization)	**23-2233457** (I.R.S. Employer Identification No.)
16 Lincoln Square, Gettysburg, Pennsylvania (Address of principal executive offices)	**17325** (Zip Code)

Registrant s telephone number, including area code: **(717) 334-3161**

Title of each class	Name of each exchange on which registered
Common Stock, $2.50 par value per share	The NASDAQ Stock Market, LLC

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

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

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

Large accelerated filer o Accelerated filer x

Non-accelerated filer o (Do not check if a smaller reporting company)

Smaller reporting company o

Emerging growth company o

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. o

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

The number of shares of the Registrant s Common Stock outstanding on November 3, 2017, was 7,019,645.

PART I - FINANCIAL INFORMATION

ACNB CORPORATION

ITEM 1 - FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

Dollars in thousands, except per share data		September 30, 2017		September 30, 2016		December 31, 2016
ASSETS						
Cash and due from banks	$	**17,882**	$	13,705	$	13,796
Interest bearing deposits with banks		**31,609**		41,686		5,135
Total Cash and Cash Equivalents		**49,491**		55,391		18,931
Securities available for sale		**158,392**		143,940		142,990
Securities held to maturity, fair value $47,373; $58,566; $55,425		**47,369**		57,562		55,568
Loans held for sale		**1,873**		1,877		1,770
Loans, net of allowance for loan losses $14,105; $14,488; $14,194		**1,222,265**		857,535		893,716
Premises and equipment		**26,590**		18,224		18,153
Restricted investment in bank stocks		**4,821**		4,191		4,349
Investment in bank-owned life insurance		**44,666**		40,476		40,742
Investments in low-income housing partnerships		**2,587**		3,003		2,899
Goodwill		**19,580**		6,308		6,308
Intangible assets		**2,752**		774		688
Foreclosed assets held for resale		**275**		309		256
Other assets		**26,974**		19,279		19,950
Total Assets	$	**1,607,635**	$	1,208,869	$	1,206,320
LIABILITIES AND STOCKHOLDERS EQUITY						
LIABILITIES						
Deposits:						
Non-interest bearing	$	**273,853**	$	186,035	$	180,593
Interest bearing		**1,038,031**		779,512		787,028
Total Deposits		**1,311,884**		965,547		967,621
Short-term borrowings		**33,806**		35,503		34,590
Long-term borrowings		**96,850**		76,500		74,250
Other liabilities		**11,839**		10,565		9,798
Total Liabilities		**1,454,379**		1,088,115		1,086,259
STOCKHOLDERS EQUITY						
Preferred stock, $2.50 par value; 20,000,000 shares authorized; no shares outstanding						
Common stock, $2.50 par value; 20,000,000 shares authorized; 7,082,245, 6,123,662 and 6,126,738 shares issued; 7,019,645, 6,061,062 and 6,064,138 shares		**17,705**		15,310		15,317

outstanding						
Treasury stock, at cost (62,600 shares)		**(728)**		(728)		(728)
Additional paid-in capital		**37,671**		10,849		10,941
Retained earnings		**103,997**		99,196		100,555
Accumulated other comprehensive loss		**(5,389)**		(3,873)		(6,024)
Total Stockholders Equity		**153,256**		120,754		120,061
Total Liabilities and Stockholders Equity	**$**	**1,607,635**	$	1,208,869	$	1,206,320

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

Dollars in thousands, except per share data	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
INTEREST INCOME				
Loans, including fees	**$ 13,990**	$ 9,150	**$ 33,484**	$ 27,054
Securities:				
Taxable	**890**	770	**2,474**	2,360
Tax-exempt	**85**	156	**352**	496
Dividends	**61**	53	**174**	159
Other	**83**	52	**120**	86
Total Interest Income	**15,109**	10,181	**36,604**	30,155
INTEREST EXPENSE				
Deposits	**1,080**	602	**2,402**	1,730
Short-term borrowings	**9**	10	**69**	38
Long-term borrowings	**458**	384	**1,274**	1,165
Total Interest Expense	**1,547**	996	**3,745**	2,933
Net Interest Income	**13,562**	9,185	**32,859**	27,222
PROVISION FOR LOAN LOSSES				
Net Interest Income after Provision for Loan Losses	**13,562**	9,185	**32,859**	27,222
OTHER INCOME				
Service charges on deposit accounts	**870**	631	**2,057**	1,734
Income from fiduciary activities	**489**	416	**1,409**	1,244
Earnings on investment in bank-owned life insurance	**276**	276	**807**	834
Gain on sales of premises and equipment				449
Service charges on ATM and debit card transactions	**490**	381	**1,229**	1,127
Commissions from insurance sales	**1,313**	1,269	**4,031**	3,700
Other	**492**	328	**1,007**	896
Total Other Income	**3,930**	3,301	**10,540**	9,984
OTHER EXPENSES				
Salaries and employee benefits	**6,715**	5,580	**18,397**	16,609
Net occupancy	**677**	481	**1,710**	1,553
Equipment	**1,039**	740	**2,666**	2,212
Other tax	**197**	201	**576**	591
Professional services	**224**	217	**807**	670
Supplies and postage	**187**	178	**524**	491
Marketing and corporate relations	**119**	123	**321**	391
FDIC and regulatory	**170**	181	**449**	532
Merger related expenses	**4,305**		**4,675**	
Intangible assets amortization	**193**	85	**355**	259
Foreclosed real estate expenses	**35**	72	**51**	112
Other operating	**1,006**	922	**2,970**	2,681
Total Other Expenses	**14,867**	8,780	**33,501**	26,101

Income before Income Taxes		**2,625**		3,706		**9,898**		11,105
PROVISION FOR INCOME TAXES		**713**		938		**2,627**		2,808
Net Income	**$**	**1,912**	$	2,768	**$**	**7,271**	$	8,297
PER SHARE DATA								
Basic earnings	**$**	**0.27**	$	0.46	**$**	**1.14**	$	1.37
Cash dividends declared	**$**	**0.20**	$	0.20	**$**	**0.60**	$	0.60

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

Dollars in thousands	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
NET INCOME	**$ 1,912**	$ 2,768	**$ 7,271**	$ 8,297
OTHER COMPREHENSIVE INCOME (LOSS)				
SECURITIES				
Unrealized gains (losses) arising during the period, net of income taxes of $28, $(158), $159 and $265, respectively	**54**	(308)	**306**	515
Reclassification adjustment for net gains included in net income, net of income taxes of $0, $0, $0 and $0, respectively (A) (C)				
PENSION				
Amortization of pension net loss, transition liability, and prior service cost, net of income taxes of $60, $59, $178 and $175, respectively (B) (C)	**109**	113	**329**	338
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	**163**	(195)	**635**	853
TOTAL COMPREHENSIVE INCOME	**$ 2,075**	$ 2,573	**$ 7,906**	$ 9,150

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

(A) Gross amounts are included in net gains on sales or calls of securities on the Consolidated Statements of Income in total other income.

(B) Gross amounts are included in the computation of net periodic benefit cost and are included in salaries and employee benefits on the Consolidated Statements of Income in total other expenses.

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

Nine Months Ended September 30, 2017 and 2016

Dollars in thousands	Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders Equity
BALANCE JANUARY 1, 2016	$ 15,256	$ (728)	$ 10,387	$ 94,526	$ (4,726)	$ 114,715
Net income				8,297		8,297
Other comprehensive income, net of taxes					853	853
Common stock shares issued (13,903 shares)	35		303			338
Restricted stock grants (7,435 shares)	19		100			119
Restricted stock compensation expense			59			59
Cash dividends declared				(3,627)		(3,627)
BALANCE SEPTEMBER 30, 2016	$ 15,310	$ (728)	$ 10,849	$ 99,196	$ (3,873)	$ 120,754
BALANCE JANUARY 1, 2017	**$ 15,317**	**$ (728)**	**$ 10,941**	**$ 100,555**	**$ (6,024)**	**$ 120,061**
Net income				**7,271**		**7,271**
Other comprehensive income, net of taxes					**635**	**635**
Common stock shares issued (949,314 shares)	**2,373**		**26,505**			**28,878**
Restricted stock grants (6,193 shares)	**15**		**105**			**120**
Restricted stock compensation expense			**120**			**120**
Cash dividends declared				**(3,829)**		**(3,829)**
BALANCE SEPTEMBER 30, 2017	**$ 17,705**	**$ (728)**	**$ 37,671**	**$ 103,997**	**$ (5,389)**	**$ 153,256**

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

Dollars in thousands	Nine Months Ended September 30, 2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	**$ 7,271**	$ 8,297
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of loans originated for sale	**(398)**	(477)
Gain on sales of foreclosed assets held for resale, including writedowns	**(36)**	(28)
Gain on sale of premises and equipment		(449)
Earnings on investment in bank-owned life insurance	**(807)**	(834)
Restricted stock compensation expense	**120**	59
Depreciation and amortization	**1,622**	1,324
Provision for loan losses		
Net amortization of investment securities premiums	**396**	391
(Increase) decrease in accrued interest receivable	**(637)**	29
Increase (decrease) in accrued interest payable	**235**	(10)
Mortgage loans originated for sale	**(21,344)**	(29,761)
Proceeds from sales of loans originated for sale	**21,639**	30,196
Decrease (increase) in other assets	**1,051**	(887)
Increase in other liabilities	**843**	966
Net Cash Provided by Operating Activities	**9,955**	8,816
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from maturities of investment securities held to maturity	**8,148**	13,809
Proceeds from maturities of investment securities available for sale	**18,486**	22,334
Purchase of investment securities available for sale	**(12,144)**	(39,127)
(Purchase) redemption of restricted investment in bank stocks	**(136)**	223
Net increase in loans	**(63,636)**	(19,660)
Bank acquisition, net of cash acquired	**6,444**	
Capital expenditures	**(1,087)**	(2,025)
Proceeds from sales of premises and equipment	**6**	1,929
Proceeds from sales of foreclosed real estate	**228**	637
Net Cash Used in Investing Activities	**(43,691)**	(21,880)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand deposits	**13,254**	19,811
Net increase in time certificates of deposits and interest bearing deposits	**37,677**	32,756
Net (decrease) increase in short-term borrowings	**(784)**	301
Proceeds from long-term borrowings	**24,600**	9,000
Repayments on long-term borrowings	**(7,000)**	(9,000)
Dividends paid	**(3,829)**	(3,627)
Common stock issued	**378**	457
Net Cash Provided by Financing Activities	**64,296**	49,698
Net Increase in Cash and Cash Equivalents	**30,560**	36,634
CASH AND CASH EQUIVALENTS BEGINNING	**18,931**	18,757
CASH AND CASH EQUIVALENTS ENDING	**$ 49,491**	$ 55,391
Supplemental disclosures of cash flow information		
Interest paid	**$ 3,510**	$ 2,943
Income taxes paid	**$ 2,850**	$ 3,200
Loans transferred to foreclosed assets held for resale and other foreclosed transactions	**$**	$ 338
Transactions related to acquisition		
Increase in assets and liabilities:		
Securities	**$ (21,624)**	$
Loans	**(264,913)**	
Premises and equipment	**(8,624)**	

Investment in bank-owned life insurance	**(3,118)**
Restricted investments in bank stocks	**(486)**
Foreclosed assets held for resale	**(211)**
Goodwill	**(13,272)**
Intangibles	**(2,418)**
Other assets	**(7,463)**
Noninterest bearing deposits	**80,006**
Interest bearing deposits	**213,327**
Trust preferred debentures	**4,688**
Other liabilities	**1,782**
Common shares issued	**28,620**

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

ACNB CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Nature of Operations

ACNB Corporation (the Corporation or ACNB), headquartered in Gettysburg, Pennsylvania, is the financial holding company for the wholly-owned subsidiaries of ACNB Bank, Gettysburg, Pennsylvania, and Russell Insurance Group, Inc. (RIG), Westminster, Maryland. ACNB Bank serves its marketplace with banking and trust services via a network of twenty-two retail banking offices located in the four southcentral Pennsylvania counties of Adams, Cumberland, Franklin and York. There is also a loan production office situated in York County, Pennsylvania.

On July 1, 2017, ACNB completed its previously announced acquisition of New Windsor Bancorp, Inc. (NW Bancorp) of Taneytown, Maryland. At the effective time of the merger, NW Bancorp merged with and into a wholly-owned subsidiary of ACNB, immediately followed by the merger of New Windsor State Bank (NWSB) with and into ACNB Bank. ACNB Bank now operates in the Maryland market as NWSB Bank, A Division of ACNB Bank . NWSB Bank, a division of ACNB Bank, serves its marketplace with banking and investment services via a network of seven retail banking offices located in Carroll County, Maryland.

RIG is a full-service insurance agency based in Westminster, Maryland, with a second location in Germantown, Maryland. The agency offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients.

The Corporation s primary source of revenue is interest income on loans and investment securities and fee income on its products and services. Expenses consist of interest expense on deposits and borrowed funds, provisions for loan losses, and other operating expenses.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly ACNB Corporation s financial position and the results of operations, comprehensive income, changes in stockholders equity, and cash flows. All such adjustments are of a normal recurring nature.

The accounting policies followed by the Corporation are set forth in Note A to the Corporation s consolidated financial statements in the 2016 ACNB Corporation Annual Report on Form 10-K, filed with the SEC on March 15, 2017. It is suggested that the consolidated financial statements contained herein be read in conjunction with the consolidated financial statements and notes included in the Corporation s Annual Report on Form 10-K. The results of operations for the three and nine month periods ended September 30, 2017, are not necessarily indicative of the results to be expected for the full year.

The Corporation has evaluated events and transactions occurring subsequent to the statement of condition date of September 30, 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.

2. Acquisition of New Windsor Bancorp, Inc.

On July 1, 2017, ACNB completed its previously-announced acquisition of NW Bancorp of Taneytown, Maryland. NW Bancorp was a locally owned and managed institution with seven locations in north central Maryland that complemented, enhanced and expanded ACNB s physical presence in north central Maryland. ACNB transacted the merger to enhance its competitive strategic position, potential prospective business opportunities, operations, management, prospective financial condition, future earnings and business prospects. Specifically, ACNB believes that the merger will enhance its business opportunities in Northern Maryland due to the combined company having a greater market share, market presence and the ability to offer more diverse (i.e. Trust Services) and more profitable products, as well as a broader based and geographically diversified branch system to enhance deposit collection and potentially improve funding costs. The fair value of total assets acquired as a result of the merger totaled $319.8 million, loans totaled $263.5 million and deposits totaled $293.3 million. Goodwill recorded in the merger was $13.3 million. In accordance with the terms of the Reorganization Agreement, dated November 21, 2016, as amended, NW Bancorp shareholders received, in aggregate, $4.5 million in cash and 938,360 shares or approximately 13% of the post transaction outstanding shares of the Corporation s common stock. The transaction was valued at $33.3 million based on the Corporation s June 30, 2017 closing price of $30.50 as quoted on NASDAQ. The results of the combined entity s operations are included in the Corporation s Consolidated Financial Statements from the date of acquisition.

The acquisition of NW Bancorp is being accounted for as a business combination using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration paid were recorded at estimated fair values on the acquisition date. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition.

The following table summarizes the consideration paid for NW Bancorp and the fair value of assets acquired and liabilities assumed as of the acquisition date:

Purchase Price Consideration in Common Stock

NW Bancorp shares outstanding		1,003,703
Shares paid cash consideration		150,555
Cash consideration (per NW Bancorp share)	$	30.00
Cash portion of purchase price	$	4,519,995
NW Bancorp shares outstanding		1,003,703
Shares paid stock consideration		853,148
Exchange ratio		1.10
Total ACNB shares issued		938,360
ACNB s share price for purposes of calculation	$	30.50
Equity portion of purchase price	$	28,619,980
Cost of shares owned by buyer	$	150,000
Total consideration paid	$	33,289,975

Allocation of Purchase Price	In thousands		
Total Purchase Price		$	33,290
Fair Value of Assets Acquired			
Cash and cash equivalents	10,964		
Investment securities	21,624		
Loans held for sale	1,463		
Loans	263,450		
Restricted stock	486		
Premises and equipment	8,624		
Core deposit intangible asset	2,418		
Other assets	10,792		
Total assets	319,821		
Fair Value of Liabilities Assumed			
Non-interest bearing deposits	80,006		
Interest bearing deposits	213,327		
Subordinated debt	4,688		
Other liabilities	1,782		
Total liabilities	299,803		
Net Assets Acquired			20,018
Goodwill Recorded in Merger		$	13,272

Pursuant to the accounting requirements, the Corporation assigned a fair value to the assets acquired and liabilities assumed of NW Bancorp. ASC 820 defines fair value as 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.

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The calculation of goodwill is subject to change for up to one year after the date of acquisition as additional information relative to the closing date estimates and uncertainties become available. Goodwill and core deposit intangibles are allocated to the banking business segment.

Fair values of the major categories of assets acquired and liabilities assumed were determined as follows:

Investment securities available-for-sale

The estimated fair values of the investment securities available for sale, primarily comprised of U.S. Government agency mortgage-backed securities, U.S. government agencies and municipal bonds, were determined using Level 2 inputs in the fair value hierarchy. The fair values were determined using independent pricing services. The Corporation s independent pricing service utilized matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific security but rather relying on the security s relationship to other benchmark quoted prices. Management reviewed the data and assumptions used in pricing the securities. A fair value premium of $361,000 was recorded and will be amortized over the estimated life of the investments using the interest rate method.

Loans

Acquired loans (impaired and non-impaired) are initially recorded at their acquisition-date fair values using Level 3 inputs. Fair values are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, expected life time losses, environmental factors, collateral values, discount rates, expected payments and expected prepayments. Specifically, the Corporation has prepared three separate loan fair value adjustments that it believed a market participant might employ in estimating the entire fair value adjustment necessary under ASC 820-10 for the acquired loan portfolio. The three-separate fair valuation methodology employed are: 1) an interest rate loan fair value adjustment (analysis available at request of the Corporation), 2) a general credit fair value adjustment (analysis available at request of the Corporation), and 3) a specific credit fair value adjustment for purchased credit impaired loans subject to ASC 310-30 procedures. The acquired loans were recorded at fair value at the acquisition date without carryover of NWSB s previously established allowance for loan losses. The fair value of the financial assets acquired included loans receivable with a gross amortized cost basis of $272,646,000. The table below illustrates the fair value adjustments made to the amortized cost basis in order to present a fair value of the loans acquired. The credit adjustment on purchased credit impaired loans is derived in accordance with ASC 310-30 and represents the portion of the loan balances that has been deemed uncollectible based on the Corporation s expectations of future cash flows for each respective loan.

In thousands		
Gross amortized cost basis at July 1, 2017	$	272,646
Interest rate fair value adjustment on pools of homogeneous loans		(731)
Credit fair value adjustment on pools of homogeneous loans		(4,501)
Credit fair value adjustment on purchased credit impaired loans		(3,964)
Fair value of acquired loans at July 1, 2017	$	263,450

For loans acquired without evidence of credit quality deterioration, ACNB prepared the interest rate loan fair value and credit fair value adjustments. Loans were grouped into homogeneous pools by characteristics such as loan type, term, collateral and rate. Market rates for similar loans were obtained from various internal and external data sources and reviewed by management for reasonableness. The average of these rates was used as the fair value interest rate a market participant would utilize. A present value approach was utilized to calculate the interest rate fair value discount of $731,000.

Additionally for loans acquired without credit deterioration, a credit fair value adjustment was calculated using a two-part credit fair value analysis: 1) expected lifetime credit migration losses; and 2) estimated fair value adjustment for certain qualitative factors. The expected lifetime losses were calculated using historical losses observed at the Bank, NWSB and peer banks. ACNB also estimated an environmental factor to apply to each loan type. The environmental factor represents potential discount which may arise due to general credit and economic factors. A credit fair value discount of $4.5 million was determined. Both the interest rate and credit fair value adjustments relate to loans acquired with evidence of credit quality deterioration will be substantially recognized as interest income on a level yield amortization method over the expected life of the loans.

The following table presents the acquired purchased credit impaired loans receivable at the Acquisition Date:

In thousands		
Contractual principal and interest at acquisition	$	13,439
Nonaccretable difference		(5,651)
Expected cash flows at acquisition		7,788
Accretable yield		(1,458)
Fair value of purchased impaired loans	$	6,330

Bank Premises

The Corporation acquired seven branches of NWSB. The fair value of NWSB s premises, including land, buildings, and improvements, was determined based upon independent third-party appraisals performed by licensed appraisers in the market in which the premises are located. The Corporation prepared an internal analysis to compare the lease contract obligations to comparable market rental rates. The Corporation believed that the leased contract rates were in a reasonable range of market rental rates and concluded that no fair market value adjustment related to leasehold interest was necessary.

Core Deposit Intangible

The fair value of the core deposit intangible was determined based on a discounted cash flow analysis using a discount rate commensurate with market participants. To calculate cash flows, deposit account servicing costs (net of deposit fee income) and interest expense on deposits were compared to the cost of alternative funding sources available through national brokered CD offering rates. The projected cash flows were developed using projected deposit attrition rates. The core deposit intangible will be amortized over ten years using the sum-of-years digits method.

Time Deposits

The fair value adjustment for time deposits represents a discount from the value of the contractual repayments of fixed-maturity deposits using prevailing market interest rates for similar-term time deposits. The time deposit discount of approximately $847,500 is being amortized into income on a level yield amortization method over the contractual life of the deposits.

Long-term Borrowings

The Corporation assumed a trust preferred subordinated debt in connection with the merger. The fair value of the trust preferred subordinated debt was determined based upon an estimated fair value from an independent brokerage firm. The trust preferred capital note was valued at discount of $312,500, which is being amortized into income on a level yield amortization method based upon the assumed market rate, and the term of the trust preferred subordinated debt instrument.

The following table presents certain pro forma information as if NWSB had been acquired on December 31, 2016. These results combine the historical results of the Corporation in the Corporation s Consolidated Statements of Income and, while certain adjustments were made for the estimated impact of certain fair value adjustments and other acquisition-related activity, they are not indicative of what would have occurred had the acquisition taken place on December 31, 2016. In particular, no adjustments have been made to eliminate the amount of NWSB s provision for loan losses that would not have been necessary had the acquired loans been recorded at fair value as of December 31, 2016. The Corporation expects to achieve further operating cost savings and other business synergies as a result of the acquisition which are not reflected in the pro forma amounts below:

In thousands		**For the Year Ended December 31, 2016**
Total revenues (net interest income plus noninterest income)	$	102,891
Net Income		13,591

Acquisition-related expenses associated with the acquisition of NWSB were $4.3 million for the three months ended September 30, 2017 and $4.7 million for the nine months ended September 30, 2017. Such costs include legal and accounting fees, lease and contract termination expenses, system conversion, operations integration, and employee severances, which have been expensed as incurred.

3. Earnings Per Share and Restricted Stock Plan

The Corporation has a simple capital structure. Basic earnings per share of common stock is computed based on 6,383,149 and 6,048,216 weighted average shares of common stock outstanding for the nine months ended September 30, 2017 and 2016, respectively, and 7,004,346 and 6,057,508 for the three months ended September 30, 2017 and 2016, respectively. All outstanding unvested restricted stock awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation.

The Corporation has a restricted stock plan available to selected officers and employees of the Bank to advance the best interest of the Corporation and its shareholders. The plan provides those persons who have responsibility for its growth with additional incentive by allowing them to acquire ownership in the Corporation and, thereby, encouraging them to contribute to the success of the Corporation. Plan expense is recognized over the vesting period of the stock issued under the plan. As of September 30, 2017, 19,301 shares were issued under this plan, of which 12,693 were fully vested and the remaining 6,608 will vest over the next year. $120,000 and $59,000 of compensation expenses related to the grants were recognized during the nine months ended September 30, 2017 and 2016, respectively. No compensation expenses were recognized during the three months ended September 30, 2017 or 2016.

4. Retirement Benefits

The components of net periodic benefit expense related to the non-contributory, defined benefit pension plan for the three and nine month periods ended September 30 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30	
In thousands	**2017**	**2016**	**2017**	**2016**
Service cost	**$ 210**	$ 199	**$ 630**	$ 597
Interest cost	**284**	284	**852**	852
Expected return on plan assets	**(630)**	(609)	**(1,890)**	(1,824)
Amortization of net loss	**169**	172	**507**	513
Net Periodic Benefit Expense	**$ 33**	$ 46	**$ 99**	$ 138

The Corporation previously disclosed in its consolidated financial statements for the year ended December 31, 2016, that it had not yet determined the amount the Bank planned on contributing to the defined benefit plan in 2017. As of September 30, 2017, this contribution amount had still not been determined. Effective April 1, 2012, no inactive or former participant in the plan is eligible to again participate in the plan, and no employee hired after March 31, 2012, is eligible to participate in the plan. As of the last annual census, ACNB Bank had a combined 358 active, vested, terminated and retired persons in the plan.

5. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had $6,974,000 in standby letters of credit as of September 30, 2017. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability, as of September 30, 2017, for guarantees under standby letters of credit issued is not material.

6. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss, net of taxes, are as follows:

In thousands	Unrealized Gains (Losses) on Securities	Pension Liability	Accumulated Other Comprehensive Loss
BALANCE SEPTEMBER 30, 2017	**$ 40**	**$ (5,429)**	**$ (5,389)**
BALANCE DECEMBER 31, 2016	$ (266)	$ (5,758)	$ (6,024)
BALANCE SEPTEMBER 30, 2016	$ 1,679	$ (5,552)	$ (3,873)

7. Segment Reporting

The Corporation has two reporting segments, the Bank and RIG. RIG is managed separately from the banking segment, which includes the Bank and related financial services that the Corporation offers through its banking subsidiary. RIG offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients.

Segment information for the nine month periods ended September 30, 2017 and 2016, is as follows:

In thousands	Banking	Insurance	Total
2017			
Net interest income and other income from external customers	**$ 39,536**	**$ 3,863**	**$ 43,399**
Income before income taxes	**9,099**	**799**	**9,898**
Total assets	**1,598,331**	**9,304**	**1,607,635**
Capital expenditures	**1,087**		**1,087**
2016			
Net interest income and other income from external customers	$ 33,871	$ 3,335	$ 37,206
Income before income taxes	10,424	681	11,105
Total assets	1,199,365	9,504	1,208,869
Capital expenditures	2,013	12	2,025

Segment information for the three month periods ended September 30, 2017 and 2016, is as follows:

In thousands	Banking	Insurance	Total
2017			
Net interest income and other income from external customers	**$ 16,321**	**$ 1,171**	**$ 17,492**
Income before income taxes	**2,424**	**201**	**2,625**
Total assets	**1,598,331**	**9,304**	**1,607,635**
Capital expenditures	**284**		**284**

2016			
Net interest income and other income from external customers	$ 11,581	$ 905	$ 12,486
Income before income taxes	3,485	221	3,706
Total assets	1,199,365	9,504	1,208,869
Capital expenditures	326		326

Customer lists intangible assets are amortized over 10 years on a straight line basis. Core deposit intangible assets are amortized over 10 years using the sum-of-years digits method. Goodwill is not amortized, but rather is analyzed annually for impairment. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested for impairment when such events occur. Tax amortization of goodwill and the intangible assets is deductible for tax purposes. Tax amortization of the goodwill associated with the NW acquisition is not deductible for federal income tax purposes.

8. Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported, net of tax, in other comprehensive income (loss).

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the security, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) if management does not expect to recover the entire amortized cost basis. In assessing potential other-than-temporary impairment for equity securities, consideration is given to management s intention and ability to hold the securities until recovery of unrealized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Amortized cost and fair value of securities at September 30, 2017, and December 31, 2016, were as follows:

In thousands		Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
SECURITIES AVAILABLE FOR SALE								
SEPTEMBER 30, 2017								
U.S. Government and agencies	**$**	**99,999**	**$**	**37**	**$**	**1,022**	**$**	**99,014**
Mortgage-backed securities, residential		**36,673**		**705**		**27**		**37,351**
State and municipal		**14,967**		**160**		**11**		**15,116**
Corporate bonds		**5,000**		**112**				**5,112**
CRA mutual fund		**1,044**				**2**		**1,042**
Stock in other banks		**647**		**110**				**757**
	$	**158,330**	**$**	**1,124**	**$**	**1,062**	**$**	**158,392**
DECEMBER 31, 2016								
U.S. Government and agencies	$	81,065	$	43	$	1,529	$	79,579
Mortgage-backed securities, residential		31,272		782		81		31,973
State and municipal		24,514		240		94		24,660
Corporate bonds		5,000		62				5,062
CRA mutual fund		1,044				9		1,035
Stock in other banks		498		183				681
	$	143,393	$	1,310	$	1,713	$	142,990
SECURITIES HELD TO MATURITY								
SEPTEMBER 30, 2017								
U.S. Government and agencies	**$**	**20,004**	**$**	**25**	**$**	**54**	**$**	**19,975**
Mortgage-backed securities, residential		**27,365**		**156**		**123**		**27,398**
	$	**47,369**	**$**	**181**	**$**	**177**	**$**	**47,373**
DECEMBER 31, 2016								
U.S. Government and agencies	$	23,017	$	26	$	54	$	22,989
Mortgage-backed securities, residential		32,551		210		325		32,436
	$	55,568	$	236	$	379	$	55,425

The following table shows the Corporation s investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2017, and December 31, 2016:

In thousands	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
SECURITIES AVAILABLE FOR SALE						
SEPTEMBER 30, 2017						
U.S. Government and agencies	**$ 65,649**	**$ 629**	**$ 15,756**	**$ 393**	**$ 81,405**	**$ 1,022**
Mortgage-backed securities, residential	**6,783**	**27**			**6,783**	**27**
State and municipal	**1,441**	**7**	**691**	**4**	**2,132**	**11**
CRA Mutual Fund	**1,042**	**2**			**1,042**	**2**
	$ 74,915	**$ 665**	**$ 16,447**	**$ 397**	**$ 91,362**	**$ 1,062**
DECEMBER 31, 2016						
U.S. Government and agencies	$ 71,454	$ 1,529	$	$	$ 71,454	$ 1,529
Mortgage-backed securities, residential	8,966	81			8,966	81
State and municipal	4,933	94			4,933	94
CRA Mutual Fund	1,035	9			1,035	9
	$ 86,388	$ 1,713	$	$	$ 86,388	$ 1,713
SECURITIES HELD TO MATURITY						
SEPTEMBER 30, 2017						
U.S. Government and agencies	**$ 12,948**	**$ 52**	**$ 1,998**	**$ 2**	**$ 14,946**	**$ 54**
Mortgage-backed securities, residential	**10,496**	**114**	**1,168**	**9**	**11,664**	**123**
	$ 23,444	**$ 166**	**$ 3,166**	**$ 11**	**$ 26,610**	**$ 177**
DECEMBER 31, 2016						
U.S. Government and agencies	$ 12,946	$ 54	$	$	$ 12,946	$ 54
Mortgage-backed securities, residential	12,956	325			12,956	325
	$ 25,902	$ 379	$	$	$ 25,902	$ 379

All mortgage-backed security investments are government sponsored enterprise (GSE) pass-through instruments issued by the Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA) or Federal Home Loan Mortgage Corporation (FHLMC), which guarantee the timely payment of principal on these investments.

At September 30, 2017, fifty-six available for sale U.S. Government and agency securities had unrealized losses that individually did not exceed 4% of amortized cost. Nine of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At September 30, 2017, eight available for sale residential mortgage-backed securities had unrealized losses that individually did not exceed 1% of amortized cost. These securities have not been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At September 30, 2017, nine available for sale state and municipal securities had unrealized losses that individually did not exceed 2% of amortized cost. Three of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At September 30, 2017, the CRA Mutual Fund had an unrealized loss that did not exceed 1% of amortized cost. This security has not been in a continuous loss position for 12 months or more. This unrealized loss relates principally to changes in interest rates subsequent to the acquisition of the specific security.

At September 30, 2017, eight held to maturity U.S. Government and agency securities had unrealized losses that individually did not exceed 1% of amortized cost. One of these securities has been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At September 30, 2017, thirteen held to maturity residential mortgage-backed securities had unrealized losses that individually did not exceed 2% of amortized cost. One of these securities has been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

In analyzing the issuer s financial condition, management considers industry analysts reports, financial performance, and projected target prices of investment analysts within a one-year time frame. Based on the above information, management has determined that none of these investments are other-than-temporarily impaired.

The fair values of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) 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 exclusively on quoted market prices for the specific securities but rather by relying on the security s relationship to other benchmark quoted prices. The Corporation uses independent service providers to provide matrix pricing.

Management routinely sells securities from its available for sale portfolio in an effort to manage and allocate the portfolio. At September 30, 2017, management had not identified any securities with an unrealized loss that it intends to sell or will be required to sell. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the security, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) if management does not expect to recover the entire amortized cost basis. In assessing potential other-than-temporary impairment for equity securities, consideration is given to management s intention and ability to hold the securities until recovery of unrealized losses.

Amortized cost and fair value at September 30, 2017, by contractual maturity, where applicable, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay with or without penalties.

	Available for Sale		**Held to Maturity**	
In thousands	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**

1 year or less	$	**6,576**	$	**6,589**	$	**8,004**	$	**7,998**
Over 1 year through 5 years		**97,681**		**96,972**		**12,000**		**11,977**
Over 5 years through 10 years		**15,709**		**15,681**				
Over 10 years								
Mortgage-backed securities, residential		**36,673**		**37,351**		**27,365**		**27,398**
CRA mutual fund		**1,044**		**1,042**				
Stock in other banks		**647**		**757**				
	$	**158,330**	$	**158,392**	$	**47,369**	$	**47,373**

The Corporation did not sell any securities available for sale during the three and nine months ended September 30, 2017 and 2016.

At September 30, 2017, and December 31, 2016, securities with a carrying value of $177,259,000 and $134,763,000, respectively, were pledged as collateral as required by law on public and trust deposits, repurchase agreements, and for other purposes.

9. Loans

The Corporation grants commercial, residential, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout southcentral Pennsylvania and northern Maryland. The ability of the Corporation s debtors to honor their contracts is dependent upon the real estate values and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The loans receivable portfolio is segmented into commercial, residential mortgage, home equity lines of credit, and consumer loans. Commercial loans consist of the following classes: commercial and industrial, commercial real estate, and commercial real estate construction.

The accrual of interest on residential mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Consumer loans (consisting of home equity lines of credit and consumer loan classes) are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued, but not collected, for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Credit Losses

The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses (the allowance) is established as losses are estimated to occur through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The reserve for unfunded lending commitments represents management s estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated statement of condition. The amount of the reserve for unfunded lending commitments is not material to the consolidated financial statements.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity, and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for the previous twelve quarters for each of these categories of loans, adjusted for qualitative risk factors. These qualitative risk factors include:

- lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;

- national, regional and local economic and business conditions, as well as the condition of various market segments, including the impact on the value of underlying collateral for collateral dependent loans;

- the nature and volume of the portfolio and terms of loans;

- the experience, ability and depth of lending management and staff;

- the volume and severity of past due, classified and nonaccrual loans, as well as other loan modifications; and,

the existence and effect of any concentrations of credit and changes in the level of such concentrations.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management s best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

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. It covers risks that are inherently difficult to quantify including, but not limited to, collateral risk, information risk, and historical charge-off risk.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal and/or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and/or 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. Impairment is measured on a loan by loan basis for commercial and commercial construction loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

A specific allocation within the allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of the Corporation s impaired loans are measured based on the estimated fair value of the loan s collateral or the discounted cash flows method.

It is the policy of the Corporation to order an updated valuation on all real estate secured loans when the loan becomes 90 days past due and there has not been an updated valuation completed within the previous 12 months. In addition, the Corporation orders third-party valuations on all impaired real estate collateralized loans within 30 days of the loan being classified as impaired. Until the valuations are completed, the Corporation utilizes the most recent independent third-party real estate valuation to estimate the need for a specific allocation to be assigned to the loan. These existing valuations are discounted downward to account for such things as the age of the existing collateral valuation, change in the condition of the real estate, change in local market and economic conditions, and other specific factors involving the collateral. Once the updated valuation is completed, the collateral value is updated accordingly.

For commercial and industrial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower s financial statements, inventory reports, accounts receivable aging reports, equipment appraisals, or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

The Corporation actively monitors the values of collateral as well as the age of the valuation of impaired loans. Management believes that the Corporation s market area is not as volatile as other areas throughout the United States, therefore valuations are ordered at least every 18 months, or more frequently if management believes that there is an indication that the fair value has declined.

For impaired loans secured by collateral other than real estate, the Corporation considers the net book value of the collateral, as recorded in the most recent financial statements of the borrower, and determines fair value based on estimates made by management.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a troubled debt restructure.

Loans whose terms are modified are classified as troubled debt restructured loans if the Corporation grants such borrowers concessions that it would not otherwise consider and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate, a below market interest rate given the risk associated with the loan, or an extension of a loan s stated maturity date. Nonaccrual troubled debt restructurings may be restored to accrual status if principal and interest payments, under the modified terms, are current for a sustained period of time and, based on a well-documented credit evaluation of the borrower s financial condition, there is reasonable assurance of repayment. Loans classified as troubled debt restructurings are generally designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into credit quality rating categories. The borrower s overall financial condition, repayment sources, guarantors, and value of collateral, if appropriate, are generally evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful, and loss. Loans classified special mention have potential weaknesses that deserve management s close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, federal and state regulatory agencies, as an integral part of their examination process, periodically review the Corporation s allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management s comprehensive analysis of the loan portfolio and economic conditions, management believes the current level of the allowance for loan losses is adequate.

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 purchases, 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 may be renewed 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 values 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, collateral appraisals, etc.

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.

Commercial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions.

Commercial Real Estate Lending The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation s commercial loan portfolio is secured primarily by commercial retail space, office buildings, and hotels. Generally, commercial real estate loans have terms that do not exceed 20 years, have loan-to-value ratios of up to 80% of the appraised value of the 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. Appraisals on properties securing commercial real estate loans originated by the Corporation are performed by independent appraisers.

Commercial real estate loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions and the complexities involved in valuing the underlying collateral.

Commercial Real Estate Construction Lending The Corporation engages in commercial real estate construction lending in its primary market area and surrounding areas. The Corporation s commercial real estate construction lending consists of commercial and residential site development loans, as well as commercial building construction and residential housing construction loans.

The Corporation s commercial real estate construction loans are generally secured with the subject property. Terms of construction loans depend on the specifics of the project, such as estimated absorption rates, estimated time to complete, etc.

In underwriting commercial real estate construction 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 project using feasibility studies, market data, etc. Appraisals on properties securing commercial real estate construction loans originated by the Corporation are performed by independent appraisers.

Commercial real estate construction loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions and the uncertainties surrounding total construction costs.

Residential Mortgage Lending One-to-four family residential mortgage loan originations, including home equity closed-end loans, are generated by the Corporation s marketing efforts, its present customers, walk-in customers, and referrals. These loans originate primarily within the Corporation s market area or with customers primarily from the market area.

The Corporation offers fixed-rate and adjustable-rate mortgage loans with terms up to a maximum of 30 years for both permanent structures and those under construction. 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 majority of the Corporation s residential mortgage loans originate with a loan-to-value of 80% or less. Loans in excess of 80% are required to have private mortgage insurance.

In underwriting one-to-four family residential real estate loans, the Corporation evaluates both the borrower s financial ability to repay the loan as agreed and the value of the property securing the loan. Properties securing real estate loans made by the Corporation are appraised by independent appraisers. The Corporation generally requires borrowers to obtain an attorney s title opinion or title insurance, as well as fire and property insurance (including flood insurance, if necessary) in an amount not less than the amount of the loan. The Corporation has not engaged in subprime residential mortgage originations.

Residential mortgage loans present a moderate level of risk due primarily to general economic conditions, as well as a continued weak housing market.

Home Equity Lines of Credit Lending The Corporation originates home equity lines of credit primarily within the Corporation s market area or with customers primarily from the market area. Home equity lines of credit are generated by the Corporation s marketing efforts, its present customers, walk-in customers, and referrals.

Home equity lines of credit are secured by the borrower s primary residence with a maximum loan-to-value of 90% and a maximum term of 20 years. In underwriting home equity lines of credit, the Corporation evaluates both the value of the property securing the loan and the borrower s 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.

Home equity lines of credit generally present a moderate level of risk due primarily to general economic conditions, as well as a continued weak housing market.

Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a higher security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market continues to be weak and property values deteriorate.

Consumer Lending The Corporation offers a variety of secured and unsecured consumer loans, including those for vehicles and mobile homes and loans secured by savings deposits. These loans originate primarily within the Corporation s market area or with customers primarily from the market area.

Consumer loan terms vary according to the type and value of collateral and the creditworthiness of the borrower. In underwriting consumer loans, a thorough analysis of the borrower s financial ability to repay the loan as agreed is performed. 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 mortgage loans or home equity lines of credit, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets such as automobiles or recreational equipment. In such cases, any repossessed collateral for a defaulted consumer 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, consumer loan collections are dependent on the borrower s continuing financial stability, and thus 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.

Acquired Loans

Acquired loans (impaired and non-impaired) are initially recorded at their acquisition-date fair values using Level 3 inputs. Fair values are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, expected life time losses, environmental factors, collateral values, discount rates, expected payments and expected prepayments. Specifically, the Corporation has prepared three separate loan fair value adjustments that it believed a market participant might employ in estimating the entire fair value adjustment necessary under ASC 820-10 for the acquired loan portfolio. The three-separate fair valuation methodology employed are: 1) an interest rate loan fair value adjustment (analysis available at request of the Corporation), 2) a general credit fair value adjustment (analysis available at request of the Corporation), and 3) a specific credit fair value adjustment for purchased credit impaired loans subject to ASC 310-30 procedures.

The carryover of allowance for loan losses related to acquired loans is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. The allowance for loan losses on acquired loans reflects only those losses incurred after acquisition and represents the present value of cash flows expected at acquisition that is no longer expected to be collected. Acquired loans are marked to fair value on the date of acquisition. In conjunction with the quarterly evaluation of the adequacy of the allowance for loan losses, the Corporation performs an analysis on acquired loans to determine whether or not there has been subsequent deterioration in relation to those loans. If deterioration has occurred, the Corporation will include these loans in the calculation of the allowance for loan losses after the initial valuation, and provide accordingly.

Upon acquisition, in accordance with Generally Accepted Accounting Principles, the Corporation has individually determined whether each acquired loan is within the scope of ASC 310-30. The Corporation s senior lending management reviewed the accounting seller s loan portfolio on a loan by loan basis to determine if any loans met the two-part definition of an impaired loan as defined by ASC 310-30: 1) Credit deterioration on the loan from its inception until the acquisition date, and 2) It is probable that not all of the contractual cash flows will be collected on the loan.

Any acquired loans that were not individually in the scope of ASC 310-30 because they didn t meet the criteria above were pooled into groups of similar loans based on various factors including borrower type, loan purpose, and collateral type. For these pools, we used certain loan information, including outstanding principal balance, estimated expected losses, weighted average maturity, weighted average margin, and weighted average interest rate along with estimated prepayment rates, expected lifetime losses, environment factors to estimate the expected cash flow for each loan pool. With regards to ASC 310-30 loans, for external disclosure purposes, the aggregate contractual cash flows less the aggregate expected cash flows will result in a credit related non-accretable yield amount. The aggregate expected cash flows less the acquisition date fair value will result in an accretable yield amount. The accretable yield reflects the contractual cash flows management expects to collect above the loan s acquisition date fair value and will be recognized over the life of the loan on a level-yield basis as a component of interest income.

Over the life of the acquired ASC 310-30 loan, we continue to estimate cash flows expected to be collected. Decreases in expected cash flows, other than from prepayments or rate adjustments, are recognized as impairments through a charge to the provision for credit losses resulting in an increase in the allowance for credit losses. Subsequent improvements in cash flows result in first, reversal of existing valuation allowances recognized subsequent to acquisition, if any, and next, an increase in the amount of accretable yield to be subsequently recognized on a prospective basis over the loan s remaining life.

Acquired ASC 310-30 loans that met the criteria for non-accrual of interest prior to acquisition are considered performing upon acquisition, regardless of whether the customer is contractually delinquent, if we can reasonably estimate the timing and amount of expected cash flows on such loans. Accordingly, we do not consider acquired contractually delinquent loans to be non-accruing and continue to recognize interest income on these loans using the accretion model.

For loans acquired without evidence of credit quality deterioration, ACNB prepared the interest rate loan fair value and credit fair value adjustments. Loans were grouped into homogeneous pools by characteristics such as loan type, term, collateral and rate. Market rates for similar loans were obtained from various internal and external data sources and reviewed by management for reasonableness. The average of these rates was used as the fair value interest rate a market participant would utilize. A present value approach was utilized to calculate the interest rate fair value discount of $731,000.

Additionally, for loans acquired without credit deterioration, a credit fair value adjustment was calculated using a two-part credit fair value analysis: 1) expected lifetime credit migration losses; and 2) estimated fair value adjustment for certain qualitative factors. The expected lifetime losses were calculated using historical losses observed at the Bank, NWSB and peer banks. ACNB also estimated an environmental factor to apply to each loan type. The environmental factor represents potential discount which may arise due to general credit and economic factors. A credit fair value discount of $4.5 million was determined. Both the interest rate and credit fair value adjustments relate to loans acquired with evidence of credit quality deterioration will be substantially recognized as interest income on a level yield amortization method over the expected life of the loans.

The following table presents the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard, and doubtful within the Corporation s internal risk rating system as of September 30, 2017, and December 31, 2016:

In thousands	Pass	Special Mention	Substandard	Doubtful	Total
SEPTEMBER 30, 2017					
Originated Loans					
Commercial and industrial	**$ 157,249**	**$ 3,348**	**$ 2,060**	**$**	**$ 162,657**
Commercial real estate	**312,432**	**19,134**	**9,355**		**340,921**
Commercial real estate construction	**31,042**	**1,009**	**250**		**32,301**
Residential mortgage	**352,238**	**3,895**	**544**		**356,677**
Home equity lines of credit	**77,486**	**352**	**90**		**77,928**
Consumer	**14,413**				**14,413**
Total Originated Loans	**944,860**	**27,738**	**12,299**		**984,897**
Acquired Loans					
Commercial and industrial	**6,123**	**177**	**80**		**6,380**
Commercial real estate	**125,703**	**13,824**	**3,225**		**142,752**
Commercial real estate construction	**7,085**	**393**			**7,478**
Residential mortgage	**58,927**	**2,932**	**3,196**		**65,055**
Home equity lines of credit	**26,726**	**88**	**371**		**27,185**
Consumer	**2,263**	**358**	**2**		**2,623**
Total Acquired Loans	**226,827**	**17,772**	**6,874**		**251,473**
Total Loans					
Commercial and industrial	**163,372**	**3,525**	**2,140**		**169,037**
Commercial real estate	**438,135**	**32,958**	**12,580**		**483,673**
Commercial real estate construction	**38,127**	**1,402**	**250**		**39,779**
Residential mortgage	**411,165**	**6,827**	**3,740**		**421,732**
Home equity lines of credit	**104,212**	**440**	**461**		**105,113**
Consumer	**16,676**	**358**	**2**		**17,036**
Total Loans	**$ 1,171,687**	**$ 45,510**	**$ 19,173**	**$**	**$ 1,236,370**
DECEMBER 31, 2016					
Commercial and industrial	$ 134,088	$ 2,355	$ 3,901	$	$ 140,344
Commercial real estate	291,762	17,376	9,842		318,980
Commercial real estate construction	13,606	1,202	463		15,271
Residential mortgage	344,048	3,617	874		348,539
Home equity lines of credit	69,190	756	126		70,072
Consumer	14,704				14,704
	$ 867,398	$ 25,306	$ 15,206	$	