MIDDLEFIELD BANC CORP
Form 10-Q
November 14, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 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

or

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

For the transition period from ___________ to ___________

Commission file number 001-36613

Middlefield Banc Corp.
(Exact Name of Registrant as Specified in its Charter)

Ohio	34-1585111
State or Other Jurisdiction of Incorporation or Organization	I.R.S. Employer Identification No.
15985 East High Street, Middlefield, Ohio	44062-0035
Address of Principal Executive Offices	Zip Code

440-632-1666
Registrant's Telephone Number, Including Area Code

Former Name, Former Address and Former

Fiscal
Year, if
Changed
Since Last
Report

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

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company **X**
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 **X**

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class: Common Stock, without par value
Outstanding at November 14, 2017: 3,214,784

MIDDLEFIELD BANC CORP.

INDEX

MIDDLEFIELD BANC CORP.

CONSOLIDATED BALANCE SHEET

(Dollar amounts in thousands, except share data)

(Unaudited)

	September 30, 2017	December 31, 2016
ASSETS		
Cash and due from banks	$47,731	$31,395
Federal funds sold	1,200	1,100
Cash and cash equivalents	48,931	32,495
Investment securities available for sale, at fair value	98,334	114,376
Loans held for sale	5,930	634
Loans	878,541	609,140
Less allowance for loan and lease losses	6,852	6,598
Net loans	871,689	602,542
Premises and equipment, net	11,768	11,203
Goodwill	15,299	4,559
Core deposit intangibles	2,848	36
Bank-owned life insurance	15,542	13,540
Other real estate owned	557	934
Accrued interest and other assets	9,928	7,502
TOTAL ASSETS	$1,080,826	$787,821
LIABILITIES		
Deposits:		
Noninterest-bearing demand	$181,550	$133,630
Interest-bearing demand	91,184	59,560
Money market	161,101	74,940
Savings	212,371	172,370
Time	251,449	189,434
Total deposits	897,655	629,934
Short-term borrowings	20,274	68,359
Other borrowings	39,273	9,437
Accrued interest and other liabilities	5,130	3,131
TOTAL LIABILITIES	962,332	710,861
STOCKHOLDERS' EQUITY		
Common stock, no par value; 10,000,000 shares authorized, 3,600,902 and 2,640,418 shares issued; 3,214,737 and 2,254,253 shares outstanding	84,722	47,943

Retained earnings	45,913	41,334
Accumulated other comprehensive income	1,377	1,201
Treasury stock, at cost; 386,165 shares	(13,518)	(13,518)
TOTAL STOCKHOLDERS' EQUITY	118,494	76,960
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,080,826	$787,821

See accompanying notes to unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

CONSOLIDATED STATEMENT OF INCOME

(Dollar amounts in thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
INTEREST AND DIVIDEND INCOME				
Interest and fees on loans	$10,443	$6,459	$29,539	$18,949
Interest-bearing deposits in other institutions	107	15	248	42
Federal funds sold	5	7	9	16
Investment securities:				
Taxable interest	159	235	600	865
Tax-exempt interest	579	687	1,846	2,227
Dividends on stock	37	17	189	74
Total interest and dividend income	11,330	7,420	32,431	22,173
INTEREST EXPENSE				
Deposits	1,468	921	3,820	2,665
Short-term borrowings	202	49	652	288
Other borrowings	148	56	413	164
Total interest expense	1,818	1,026	4,885	3,117
NET INTEREST INCOME	9,512	6,394	27,546	19,056
Provision for loan losses	280	105	615	315
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	9,232	6,289	26,931	18,741
NONINTEREST INCOME				
Service charges on deposit accounts	479	505	1,397	1,443
Investment securities gains, net	398	-	886	303
Earnings on bank-owned life insurance	109	101	316	297
Gain on sale of loans	255	129	720	322
Other income	200	242	622	694
Total noninterest income	1,441	977	3,941	3,059
NONINTEREST EXPENSE				
Salaries and employee benefits	3,725	2,677	10,624	7,740
Occupancy expense	476	306	1,397	933
Equipment expense	242	221	789	700

Data processing costs	468	334	1,376	928
Ohio state franchise tax	186	186	558	448
Federal deposit insurance expense	165	132	368	396
Professional fees	434	547	1,230	1,057
Net loss on other real estate owned	18	48	88	247
Advertising expense	248	206	660	604
Core deposit intangible amortization	101	10	276	30
Merger expense	338	-	1,032	-
Other expense	896	995	2,870	2,832
Total noninterest expense	7,297	5,662	21,268	15,915
Income before income taxes	3,376	1,604	9,604	5,885
Income taxes	914	261	2,535	1,129
NET INCOME	$2,462	$1,343	$7,069	$4,756
EARNINGS PER SHARE				
Basic	$0.77	$0.60	$2.38	$2.31
Diluted	0.76	0.60	2.37	2.30
DIVIDENDS DECLARED PER SHARE	$0.27	$0.27	$0.81	$0.81

See accompanying notes to unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Dollar amounts in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income	$2,462	$1,343	$7,069	$4,756
Other comprehensive income:				
Net unrealized holding gain (loss) on available-for-sale securities	(264)	(400)	1,153	2,153
Tax effect	89	137	(392)	(732)
Reclassification adjustment for investment securities gain included in net income	(398)	-	(886)	(303)
Tax effect	135	-	301	103
Total other comprehensive income (loss)	(438)	(263)	176	1,221
Comprehensive income	$2,024	$1,080	$7,245	$5,977

See accompanying notes to unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(Dollar amounts in thousands, except share and per share data)

(Unaudited)

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2016	$ 47,943	$ 41,334	$ 1,201	$ (13,518)	$ 76,960
Net income		7,069			7,069
Other comprehensive income			176		176
Common stock issued in business combination (544,610 shares)	20,995				20,995
Other common stock issuances, net of offering cost (399,008 shares)	15,164				15,164
Dividend reinvestment and purchase plan (8,917 shares)	407				407
Stock options exercised (7,126 shares)	180				180
Stock issued in connection with equity awards, net (823 shares)	33				33
Cash dividends declared ($0.81 per share)		(2,490)			(2,490)
Balance, September 30, 2017	$ 84,722	$ 45,913	$ 1,377	$ (13,518)	$ 118,494

See accompanying notes to unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

(Unaudited)

	Nine Months Ended September 30, 2017	2016
OPERATING ACTIVITIES		
Net income	$7,069	$4,756
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	615	315
Investment securities gain, net	(886)	(303)
Depreciation and amortization of premises and equipment, net	797	744
Amortization of premium and discount on investment securities, net	343	352
Accretion of deferred loan fees, net	(246)	(150)
Amortization of core deposit intangibles	275	30
Equity-based compensation	33	-
Origination of loans held for sale	(13,345)	(15,497)
Proceeds from sale of loans	7,811	16,046
Gain on sale of loans	(239)	(322)
Origination of student loans held for sale	(321,942)	-
Proceeds from sale of student loans	328,853	-
Gain on sale of student loans	(481)	-
Earnings on bank-owned life insurance	(316)	(297)
Deferred income tax	(532)	224
Net (gain) loss on other real estate owned	(211)	247
(Increase) in accrued interest receivable	(311)	(139)
Increase (decrease) in accrued interest payable	124	(4)
Other, net	(2,193)	253
Net cash provided by operating activities	5,218	6,255
INVESTING ACTIVITIES		
Investment securities available for sale:		
Proceeds from repayments and maturities	9,560	17,896
Proceeds from sale of securities	6,474	9,115
Purchases	(250)	(1,744)
Increase in loans, net	(75,307)	(53,430)
Proceeds from the sale of other real estate owned	1,767	555
Purchase of bank-owned life insurance	(5)	-
Purchase of premises and equipment	(1,037)	(679)
Purchase of restricted stock	(899)	-
Redemption of restricted stock	795	-

Acquisition, net of cash paid	5,431	-
Net cash used in investing activities	(53,471)	(28,287)
FINANCING ACTIVITIES		
Net increase in deposits	69,677	14,895
(Decrease) in short-term borrowings, net	(48,085)	(3,022)
Repayment of other borrowings	(164)	(226)
Proceeds from other borrowings	30,000	-
Proceeds from common stock issued	15,164	11,239
Net cash from common stock transactions	180	-
Proceeds from dividend reinvestment and purchase plan	407	382
Cash dividends	(2,490)	(1,710)
Net cash provided by financing activities	64,689	21,558
Increase (decrease) in cash and cash equivalents	16,436	(474)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	32,495	23,750
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$48,931	$23,276

See accompanying notes to unaudited consolidated financial statements.

SUPPLEMENTAL INFORMATION		
Cash paid during the year for:		
Interest on deposits and borrowings	$4,761	$3,121
Income taxes	4,455	475
Noncash investing transactions:		
Transfers from loans to other real estate owned	$1,179	$595
Common stock issued in business acquisition	20,995	-
Acquisition of Liberty Bank		
Noncash assets acquired		
Loans		$195,388
Loans held for sale		5,953
Premises and equipment, net		325
Accrued interest receivable		440
Bank-owned life insurance		1,681
Core deposit intangible		3,087
Other assets		997
Goodwill		10,740
		218,611
Liabilities assumed		
Time deposits		(30,744)
Deposits other than time deposits		(167,300)
Accrued interest payable		(47)
Deferred taxes		(1,134)
Other liabilities		(2,754)
		(201,979)
Liberty stock acquired in business combination		(1,068)
Net noncash assets acquired		$15,564
Cash and cash equivalents acquired, net		$5,431

See accompanying notes to unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

The consolidated financial statements of Middlefield Banc Corp. ("Company") include its bank subsidiary, The Middlefield Banking Company (“MBC” or “Middlefield Bank”), and a nonbank asset resolution subsidiary EMORECO, Inc. All significant inter-company items have been eliminated.

On January 12, 2017, the Company completed its acquisition of Liberty Bank, N.A. (“Liberty”), pursuant to a previously announced definitive merger agreement. Under the terms of the merger agreement, Liberty shareholders received $37.96 in cash or 1.1934 shares of the Company’s common stock in exchange for each share of Liberty common stock they owned immediately prior to the merger. The Company issued 544,610 shares of its common stock in the merger and the aggregate merger consideration was approximately $42.2 million. Upon closing, Liberty was merged into MBC, and its three full-service bank offices, in Twinsburg in northern Summit County and in Beachwood and Solon in eastern Cuyahoga County, became offices of MBC. The systems integration of Liberty into MBC was completed in February.

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles and the instructions for Form 10-Q and Article 10 of Regulation S-X. In management’s opinion, the financial statements include all adjustments, consisting of normal recurring adjustments, that the Company considers necessary to fairly state the Company’s financial position and the results of operations and cash flows. The consolidated balance sheet at December 31, 2016, has been derived from the audited financial statements at that date but does not include all of the necessary informational disclosures and footnotes as required by U.S. generally accepted accounting principles. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included with the Company’s Form 10-K for the year ended December 31, 2016. The results of the Company’s operations for any interim period are not necessarily indicative for the results of the Company’s operations for any other interim period or for a full fiscal year.

Recent Accounting Pronouncements –

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* which will supersede the revenue recognition requirements in Topic 605, *Revenue Recognition,* and most industry-specific revenue recognition guidance throughout the Accounting Standards Codification. Under ASU No. 2014-09, revenue should be recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In applying the guidance, an entity should 1) identify the contract(s) with a customer, 2) identify the performance obligation in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract, and 5) recognize revenue when the entity satisfies a performance obligation. For public entities, the amendments in this update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. In August 2015, the FASB issued ASU No. 2015-14 delaying the effective date of ASU No. 2014-09. Public business entities, certain not-for profit entities, and certain employee benefit plans should apply the guidance in ASU No. 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Because this guidance does not apply to revenue associated with financial instruments, including loans or securities, the new guidance is not expected to have a material impact on the components of income most closely associated with financial instruments, including securities gains/losses and interest income. The Company is currently evaluating this guidance to determine the impact on components of noninterest income. Although management has not completed its evaluation of the impact of adoption of the ASU on noninterest income, management does not expect the amount or timing of the recognition of such revenue to be materially impacted and does not expect adoption to have a material impact on the Company’s consolidated financial position, results of operations or cash flows.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company’s preliminary analysis of its current portfolio, the impact to the Company’s balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments*, which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recoding of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is 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. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, *Business Combinations (Topic 805), Clarifying the Definition of a Business*, which provides a more robust framework to use in determining when a set of assets and activities (collectively referred to as a "set") is a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated. Public business entities should apply the amendments in this Update to annual periods beginning after December 15, 2017, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The amendments in this Update should be applied prospectively on or after the effective date. This Update is not expected to have a significant impact on the Company's financial statements.

In January 2017, the FASB issued ASU 2017-04, *Simplifying the Test for Goodwill Impairment*. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in this Update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. A public business entity that is a U.S. Securities and Exchange Commission ("SEC") filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities that are adopting the amendments in this Update should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2017, the FASB issued ASU 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20)*. The amendments in this Update shorten 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. For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. 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 should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. This Update is not expected to have a significant impact on the Company’s financial statements.

In May 2017, the FASB issued ASU 2017-09, *Compensation – Stock Compensation (Topic 718)*, which affects any entity that changes the terms or conditions of a share-based payment award. This Update amends the definition of modification by qualifying that modification accounting does not apply to changes to outstanding share-based payment awards that do not affect the total fair value, vesting requirements, or equity/liability classification of the awards. The amendments in this Update are effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for (1) public business entities for reporting periods for which financial statements have not yet been issued and (2) all other entities for reporting periods for which financial statements have not yet been made available for issuance. The amendments in this Update should be applied prospectively to an award modified on or after the adoption date. The Company is currently evaluating the impact the adoption of the standard will have on its financial position or results of operations.

NOTE 2 - STOCK-BASED COMPENSATION

The Company had no unvested stock options outstanding or unrecognized stock-based compensation costs outstanding as of September 30, 2017 and 2016.

Stock option activity during the nine months ended September 30 is as follows:

	2017	Weighted-average Exercise Price	2016	Weighted-average Exercise Price
Outstanding, January 1	29,324	$ 23.67	31,949	$ 25.03
Exercised	(7,949)	29.87	-	-
Outstanding, September 30	21,375	$ 21.37	31,949	$ 25.03
Exercisable, September 30	21,375	$ 21.37	31,949	$ 25.03

NOTE 3 - EARNINGS PER SHARE

The Company provides dual presentation of basic and diluted earnings per share. Basic earnings per share is calculated by dividing net income by the average shares outstanding. Diluted earnings per share adds the dilutive effects of stock options to average shares outstanding.

The following table sets forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computation.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2017	2016	2017	2016
Weighted-average common shares outstanding	3,598,500	2,633,752	3,352,316	2,445,821

Average treasury stock shares	(386,165)	(386,165)	(386,165)	(386,165)
Weighted-average common shares and common stock equivalents used to calculate basic earnings per share	3,212,335	2,247,587	2,966,151	2,059,656
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	11,418	8,643	12,592	8,876
Weighted-average common shares and common stock equivalents used to calculate diluted earnings per share	3,223,753	2,256,230	2,978,743	2,068,532

Options to purchase 21,375 shares of common stock, at prices ranging from $17.55 to $37.00, were outstanding during the three and nine months ended September 30, 2017. Of those options, 21,375 were considered dilutive for the three and nine month periods based on the market price exceeding the strike price and no options were anti-dilutive.

Options to purchase 31,949 shares of common stock, at prices ranging from $17.55 to $40.24, were outstanding during the three and nine months ended September 30, 2016. Of those options, 24,700 were considered dilutive for the three and nine month periods based on the market price exceeding the strike price and 7,249 options were anti-dilutive.

NOTE 4 - FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. GAAP established a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following levels:

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

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

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

The following tables present the assets measured on a recurring basis on the Consolidated Balance Sheet at their fair value by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

		September 30, 2017		
(Dollar amounts in thousands)	Level I	Level II	Level III	Total

Assets measured on a recurring basis:							
U.S. government agency securities	$	-	$9,094	$	-	$9,094
Obligations of states and political subdivisions		-	72,094		-	72,094
Mortgage-backed securities in government-sponsored entities		-	16,579		-	16,579
Total debt securities		-	97,767		-	97,767
Equity securities in financial institutions		-	567		-	567
Total	$	-	$98,334	$	-	$98,334

			December 31, 2016			
(Dollar amounts in thousands)	Level I		Level II	Level III		Total
Assets measured on a recurring basis:						
U.S. government agency securities	$	-	$10,236	$	-	$10,236
Obligations of states and political subdivisions		-	81,223		-	81,223
Mortgage-backed securities in government-sponsored entities		-	20,069		-	20,069
Private-label mortgage-backed securities		-	1,709		-	1,709
Total debt securities		-	113,237		-	113,237
Equity securities in financial institutions		-	1,139		-	1,139
Total	$	-	$114,376	$	-	$114,376

The Company obtains fair values from an independent pricing service which represent either quoted market prices for the identical securities (Level I inputs) or fair values determined by pricing models using a market approach that considers observable market data, such as interest rate volatilities, LIBOR yield curve, credit spreads and prices from market makers and live trading systems (Level II).

The Company uses prices compiled by third party vendors.

Impaired Loans – The Company has measured impairment on collateral-dependent impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral dependent loan is less than the carrying amount of the loan, a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the following table as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is not included in the following table as it is not currently being carried at its fair value. The fair values in the following table exclude estimated selling costs of $437,000 at September 30, 2017.

Other Real Estate Owned (OREO) – OREO is carried at the lower of cost or fair value, which is measured at the date of foreclosure. If the fair value of the collateral exceeds the carrying amount of the loan, no charge-off or adjustment is necessary, the loan is not considered to be carried at fair value, and is therefore not included in the following table. If the fair value of the collateral is less than the carrying amount of the loan, management will charge the loan down to its estimated realizable value. The fair value of OREO is based on the appraised value of the property, which is generally unadjusted by management and is based on comparable sales for similar properties in the same geographic region as the subject property, and is included in the following table as a Level II measurement. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. In these cases, the loans are categorized in the following table as Level III measurement since these adjustments are considered to be unobservable inputs. Income and expenses from operations and further declines in the fair value of the collateral subsequent to foreclosure are included in net expenses from OREO.

The following tables present the assets measured on a nonrecurring basis on the Consolidated Balance Sheet at their fair value by level within the fair value hierarchy. Collateral-dependent impaired loans are carried at fair value if they have been charged down to fair value or if a specific valuation allowance has been established. A new cost basis is established at the time a property is initially recorded in OREO. OREO properties are carried at fair value if a devaluation has been taken to the property's value subsequent to the initial measurement.

		September 30, 2017		
(Dollar amounts in thousands)	Level I	Level II	Level III	Total
Assets measured on a nonrecurring basis:				
Impaired loans	$ -	$ -	$ 1,620	$ 1,620
Other real estate owned	-	-	81	81

December 31, 2016

(Dollar amounts in thousands)	Level I	Level II	Level III	Total
Assets measured on a nonrecurring basis:				
Impaired loans	$ -	$ -	$ 6,498	$ 6,498
Other real estate owned	-	-	511	511

13

The following tables present additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company uses Level III inputs to determine fair value:

(Dollar amounts in thousands)	Quantitative Information about Level III Fair Value Measurements			
	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
September 30, 2017				
Impaired loans	$1,620	Appraisal of collateral (1)	Appraisal adjustments (2)	3.3% to 8.3% (5.3%)
Other real estate owned	$81	Appraisal of collateral (1)	Appraisal adjustments (2)	0.0% to 10.0%

(Dollar amounts in thousands)	Quantitative Information about Level III Fair Value Measurements			
	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
December 31, 2016				
Impaired loans	$ 1,570	Appraisal of collateral (1)	Appraisal adjustments (2)	0.0% to 59.7% (28.2%)
Other real estate owned	$ 511	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to 10.0%

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various level III inputs which are not identifiable, less any associated allowance.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

The estimated fair value of the Company’s financial instruments is as follows:

September 30, 2017				
Carrying Value	Level I	Level II	Level III	Total Fair Value
(Dollar amounts in thousands)				

Financial assets:					
Cash and cash equivalents	$48,931	$48,931	$-	$-	$48,931
Investment securities					
Available for sale	98,334	-	98,334	-	98,334
Loans held for sale	5,930	4,995	935	-	5,930
Net loans	871,689	-	-	879,206	879,206
Bank-owned life insurance	15,542	15,542	-	-	15,542
Federal Home Loan Bank stock	3,589	3,589	-	-	3,589
Accrued interest receivable	3,177	3,177	-	-	3,177
Financial liabilities:					
Deposits	$897,655	$646,206	$-	$252,112	$898,318
Short-term borrowings	20,274	20,274	-	-	20,274
Other borrowings	39,273	-	-	39,306	39,306
Accrued interest payable	566	566	-	-	566

14

	December 31, 2016				
	Carrying Value	Level I	Level II	Level III	Total Fair Value
	(Dollar amounts in thousands)				
Financial assets:					
Cash and cash equivalents	$32,495	$32,495	$-	$-	$32,495
Investment securities					
Available for sale	114,376	-	114,376	-	114,376
Loans held for sale	634	-	634	-	634
Net loans	602,542	-	-	604,447	604,447
Bank-owned life insurance	13,540	13,540	-	-	13,540
Restricted stock	2,204	2,204	-	-	2,204
Accrued interest receivable	2,426	2,426	-	-	2,426
Financial liabilities:					
Deposits	$629,934	$440,500	$-	$189,871	$630,371
Short-term borrowings	68,359	68,359	-	-	68,359
Other borrowings	9,437	-	-	9,512	9,512
Accrued interest payable	395	395	-	-	395

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract which creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas or simulation modeling. Since many of these assumptions result from judgments made by management based upon estimates which are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

As certain assets such as deferred tax assets and premises and equipment are not considered financial instruments, the estimated fair value of financial instruments would not represent the full value of the Company.

The Company employed simulation modeling in determining the estimated fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

Cash and Cash Equivalents, Federal Home Loan Bank Stock, Accrued Interest Receivable, Accrued Interest Payable, and Short-Term Borrowings

The fair value is equal to the current carrying value.

Bank-Owned Life Insurance

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

Investment Securities Available for Sale

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

Loans Held for Sale

Loans held for sale are carried at lower of cost or fair value. The fair value of loans held for sale is based on secondary market pricing on portfolios with similar characteristics. The changes in fair value of the assets are largely driven by changes in interest rates subsequent to loan funding and changes in the fair value of servicing associated with the mortgage loan held for sale. Within this total are student loans held for sale for which the fair value is based on readily determinable market prices, which is a level I Price.

Net Loans

The fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality. Where quoted market prices were available, primarily for certain residential mortgage loans, such market rates were used as estimates for fair value.

Deposits and Other Borrowings

The fair values of certificates of deposit and other borrowings are based on the discounted value of contractual cash flows. The discount rates are estimated using rates currently offered for similar instruments with similar remaining maturities. Demand, savings, and money market deposits are valued at the amount payable on demand as of period end.

Commitments to Extend Credit

These financial instruments are generally not subject to sale, and estimated fair values are not readily available. The carrying value, represented by the net deferred fee arising from the unrecognized commitment or letter of credit, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure.

NOTE 5 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The following tables present the changes in accumulated other comprehensive income by component net of tax for the three and nine months ended September 30, 2017 and 2016, respectively:

(Dollars in thousands)	Unrealized gains on available-for-sale securities	
Balance as of June 30, 2017	$ 1,815	
Other comprehensive income before reclassification	(175	)
Amount reclassified from accumulated other comprehensive income	(263	)
Period change	(438	)
Balance at September 30, 2017	$ 1,377	
Balance as of December 31, 2016	$ 1,201	
Other comprehensive income before reclassification	761	
Amount reclassified from accumulated other comprehensive income	(585	)

Period change		176
Balance at September 30, 2017	$	1,377

(Dollars in thousands)		Unrealized gains on available-for-sale securities	
Balance as of June 30, 2016	$	3,879	
Other comprehensive loss before reclassification		(263	)
Amount reclassified from accumulated other comprehensive income		-	
Period change		(263	)
Balance at September 30, 2016	$	3,616	
Balance as of December 31, 2015	$	2,395	
Other comprehensive income before reclassification		1,421	
Amount reclassified from accumulated other comprehensive income		(200	)
Period change		1,221	
Balance at September 30, 2016	$	3,616	

(a) All amounts are net of tax. Amounts in parentheses indicate debits to accumulated other comprehensive income.

The following tables present significant amounts reclassified out of each component of accumulated other comprehensive income:

(Dollars in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income (a) For the Three Months Ended		Affected Line Item in the Statement Where Net Income is
Details about other comprehensive income	September 30, 2017	September 30, 2016	Presented
Unrealized gains on available-for-sale securities			
	$ 398	$ -	Investment securities gains, net
	(135)	-	Income taxes
	$ 263	$ -	

(Dollars in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income (a) For the Nine Months Ended		Affected Line Item in the Statement Where Net Income is
Details about other comprehensive income	September 30, 2017	September 30, 2016	Presented
Unrealized gains on available-for-sale securities			
	$ 886	$ 303	Investment securities gains, net
	(301)	(103)	Income taxes
	$ 585	$ 200	

(a) Amounts in parentheses indicate expenses and other amounts indicate income.

NOTE 6 - INVESTMENT SECURITIES AVAILABLE FOR SALE

The amortized cost and fair values of securities available for sale are as follows:

September 30, 2017

(Dollar amounts in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	$9,004	$ 146	$ (56)	$9,094
Obligations of states and political subdivisions:				
Taxable	505	12	-	517
Tax-exempt	69,750	1,886	(59)	71,577
Mortgage-backed securities in government-sponsored entities	16,574	175	(170)	16,579
Total debt securities	95,833	2,219	(285)	97,767
Equity securities in financial institutions	415	152	-	567
Total	$96,248	$ 2,371	$ (285)	$98,334

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	$10,158	$ 174	$ (96)	$10,236
Obligations of states and political subdivisions:				
Taxable	1,615	129	(4)	1,740
Tax-exempt	78,327	1,678	(522)	79,483
Mortgage-backed securities in government-sponsored entities	20,128	202	(261)	20,069
Private-label mortgage-backed securities	1,579			