PEOPLES FINANCIAL SERVICES CORP.
Form 10-Q
August 07, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended June 30, 2018

or

Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

for the transition period from

001-36388

(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

Pennsylvania	23-2391852

(State of incorporation)	(IRS Employer ID Number)
150 North Washington Avenue, Scranton, PA	18503
(Address of principal executive offices)	(Zip code)

(570) 346-7741

(Registrant's telephone number, including area code)

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of the registrant's common stock, as of the latest practicable date: 7,399,054 at July 31, 2018.

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PEOPLES FINANCIAL SERVICES CORP.

FORM 10-Q

For the Quarter Ended June 30, 2018

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Peoples Financial Services Corp.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)

	(Unaudited) June 30, 2018	December 31, 2017
Assets:		
Cash and due from banks:		
Cash and due from banks	$ 35,249	$ 36,336
Interest-bearing deposits in other banks	130	1,152
Total cash and due from banks	35,379	37,488
Investment securities:		
Available-for-sale	275,050	272,502
Equity investments carried at fair value	278	46
Held-to-maturity: Fair value June 30, 2018, $8,758; December 31, 2017, $9,547	8,780	9,274
Total investment securities	284,108	281,822
Loans, net	1,753,389	1,693,065
Less: allowance for loan losses	19,573	18,960
Net loans	1,733,816	1,674,105
Loans held for sale		106
Premises and equipment, net	37,148	37,557
Accrued interest receivable	6,802	6,936
Goodwill	63,370	63,370
Intangible assets, net	2,727	3,178
Other assets	72,276	64,469
Total assets	$ 2,235,626	$ 2,169,031
Liabilities:		
Deposits:		
Noninterest-bearing	$ 400,518	$ 380,729
Interest-bearing	1,318,343	1,338,289
Total deposits	1,718,861	1,719,018
Short-term borrowings	187,450	123,675
Long-term debt	48,911	49,734
Accrued interest payable	538	497
Other liabilities	10,322	11,131
Total liabilities	1,966,082	1,904,055
Stockholders’ equity:		
Common stock, par value $2.00, authorized 25,000,000 shares, issued and outstanding 7,399,054 shares at June 30, 2018 and 7,396,505 at December 31, 2017	14,798	14,793
Capital surplus	135,143	135,043

Retained earnings	128,356	121,353
Accumulated other comprehensive loss	(8,753)	(6,213)
Total stockholders' equity	269,544	264,976
Total liabilities and stockholders' equity	$ 2,235,626	$ 2,169,031

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands, except per share data)

	Three Months Ended		Six Months Ended	
June 30,	2018	2017	2018	2017
Interest income:				
Interest and fees on loans:				
Taxable	$ 18,239	$ 15,945	$ 35,748	$ 31,486
Tax-exempt	871	795	1,741	1,521
Interest and dividends on investment securities:				
Taxable	934	719	1,792	1,416
Tax-exempt	661	752	1,362	1,546
Dividends	19	12	35	24
Interest on interest-bearing deposits in other banks	42	38	82	67
Total interest income	20,766	18,261	40,760	36,060
Interest expense:				
Interest on deposits	1,959	1,529	3,793	2,963
Interest on short-term borrowings	841	248	1,508	422
Interest on long-term debt	315	349	621	697
Total interest expense	3,115	2,126	5,922	4,082
Net interest income	17,651	16,135	34,838	31,978
Provision for loan losses	1,050	1,200	2,100	2,400
Net interest income after provision for loan losses	16,601	14,935	32,738	29,578
Noninterest income:				
Service charges, fees and commissions	1,885	1,682	3,973	3,254
Merchant services income	309	1,178	559	2,193
Commission and fees on fiduciary activities	485	494	982	1,002
Wealth management income	332	348	743	667
Mortgage banking income	162	204	309	383
Life insurance investment income	191	195	378	384
Net unrealized gain on equity investment securities	8			
Net gain on sale of credit card loans	291		291	
Net gain on sale of merchant services business		2,278		2,278
Total noninterest income	3,663	6,379	7,235	10,161
Noninterest expense:				
Salaries and employee benefits expense	7,390	7,026	14,345	13,301
Net occupancy and equipment expense	2,720	2,450	5,534	4,844

Merchant services expense	1	1,033	3	1,763
Amortization of intangible assets	220	258	450	526
Professional fees and outside services	446	756	1,069	1,285
FDIC insurance and assessments	297	239	583	366
Donations	343	283	656	555
Other expenses	2,079	1,957	3,937	3,718
Total noninterest expense	13,496	14,002	26,577	26,358
Income before income taxes	6,768	7,312	13,396	13,381
Income tax expense	811	1,653	1,585	2,922
Net income	5,957	5,659	11,811	10,459
Other comprehensive (loss) income:				
Unrealized (loss) gain on investment securities available-for-sale	(839)	1,184	(3,215)	1,457
Income tax (benefit) expense	(176)	415	(677)	510
Other comprehensive (loss) income, net of income taxes	(663)	769	(2,538)	947
Comprehensive income	$ 5,294	$ 6,428	$ 9,273	$ 11,406
Per share data:				
Net income:				
Basic	$ 0.81	$ 0.76	$ 1.60	$ 1.41
Diluted	$ 0.81	$ 0.76	$ 1.60	$ 1.41
Average common shares outstanding:				
Basic	7,396,533	7,396,163	7,396,519	7,395,158
Diluted	7,396,533	7,396,163	7,396,519	7,395,158
Dividends declared	$ 0.33	$ 0.31	$ 0.65	$ 0.62

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands, except per share data)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2018	$ 14,793	$ 135,043	$ 121,353	$ (6,213)	$ 264,976
Stock based compensation		105			105
Net income			11,811		11,811
Other comprehensive income, net of income taxes				(2,538)	(2,538)
Dividends declared: $0.65 per share			(4,810)		(4,810)
Reclassification related to adoption of ASU 2016-01			2	(2)	
Common stock grants awarded, net of unearned compensation of $113: 2,548 shares	5	(5)			
Balance, June 30, 2018	$ 14,798	$ 135,143	$ 128,356	$ (8,753)	$ 269,544
Balance, January 1, 2017	$ 14,788	$ 134,871	$ 111,114	$ (4,155)	$ 256,618
Stock based compensation		70			70
Net income			10,459		10,459
Other comprehensive income, net of income taxes				947	947
Dividends declared: $0.62 per share			(4,585)		(4,585)
Common stock grants awarded, net of unearned compensation of $81: 2,020 shares	4	(4)			
Balance, June 30, 2017	$ 14,792	$ 134,937	$ 116,988	$ (3,208)	$ 263,509

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

For the Six Months Ended June 30,	2018	2017
Cash flows from operating activities:		
Net income	$ 11,811	$ 10,459
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	1,140	884
Amortization of deferred loan costs	482	427
Amortization of intangibles	450	526
Amortization of low income housing partnerships	233	235
Provision for loan losses	2,100	2,400
Net loss (gain) on sale of other real estate owned	19	(5)
Loans originated for sale	(5,932)	(10,411)
Proceeds from sale of loans originated for sale	6,074	10,520
Net gain on sale of loans originated for sale	(36)	(109)
Net amortization of investment securities	1,197	1,469
Net gain on sale of credit card loans held for sale	(291)	
Net gain on sale of merchant services business		(2,278)
Life insurance investment income	(378)	(384)
Stock based compensation	105	70
Net change in:		
Accrued interest receivable	134	22
Other assets	(1,187)	(2,136)
Accrued interest payable	41	(31)
Other liabilities	(914)	(116)
Net cash provided by operating activities	15,048	11,542
Cash flows from investing activities:		
Proceeds from repayments of investment securities:		
Available-for-sale	15,445	21,594
Held-to-maturity	485	637
Purchases of investment securities:		
Available-for-sale	(22,627)	(18,958)
Net purchase of restricted equity securities	(2,794)	(703)
Proceeds from sale of student loan portfolio	3,171	
Net increase in lending activities	(68,291)	(65,625)
Purchases of premises and equipment	(1,071)	(3,516)
Proceeds from the sale of premises and equipment	340	
Proceeds from the sale of merchant services business		2,300
Proceeds from sale of other real estate owned	200	272
Net cash used in investing activities	(75,142)	(63,999)
Cash flows from financing activities:		
Net (decrease) increase in deposits	(157)	50,676

Repayment of long-term debt	(823)	(974)
Net increase in short-term borrowings	63,775	8,800
Cash dividends paid	(4,810)	(4,585)
Net cash provided by financing activities	57,985	53,917
Net (decrease) increase in cash and cash equivalents	(2,109)	1,460
Cash and cash equivalents at beginning of period	37,488	39,941
Cash and cash equivalents at end of period	$ 35,379	$ 41,401

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

For the Six Months Ended June 30,	2018	2017
Supplemental disclosures:		
Cash paid during the period for:		
Interest	$ 5,881	$ 4,113
Income taxes	2,050	3,100
Noncash items:		
Transfers of loans to other real estate	$ 495	$ 279

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

1. Summary of significant accounting policies:

Nature of operations:

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company ("Peoples Bank"). Unless the context indicates otherwise, all references in this quarterly report to the "Peoples", "Company", "Bank", "we", "us" and "our" refer to Peoples Financial Services Corp., its subsidiaries and its and their respectiv predecessors. The Company services its retail and commercial customers through twenty-seven full-service community banking offices located within the Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York.

Basis of presentation:

The accompanying unaudited consolidated financial statements of the Company 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 10-01 of Regulation S-X. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. All significant intercompany balances and transactions have been eliminated in consolidation. Prior-period amounts are reclassified when necessary to conform to the current year's presentation. These reclassifications did not have any effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and six months ended and as of June 30, 2018, are not necessarily indicative of the results of operations and financial position that may be expected in the future.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates that are particularly susceptible to material change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, the valuation of deferred tax assets, determination of other-than-temporary impairment losses on securities, impairment of goodwill and fair value of assets acquired and liabilities assumed in business combinations. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, reference is made to the Company's Annual Report on Form 10-K for the period ended December 31, 2017.

Revenue from Contracts with Customers:

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. The following is a discussion of revenues within the scope of the new guidance:

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

Service charges, fees and commissions. Service charges, fees and commissions on deposit accounts include fees for banking services provided, overdrafts and non-sufficient funds. Revenue is generally recognized in accordance with published deposit account agreements for retail accounts or contractual agreements for commercial accounts. Our deposit services also include our ATM and debit card interchange revenue that is presented gross of the associated costs. Interchange revenue is generated by our deposit customers' usage and volume of activity. Interchange rates are not controlled by the Company, which effectively acts as processor that collects and remits payments associated with customer debit card transactions.

Commission and fees on fiduciary activities. Commission and fees on fiduciary activities includes fees and commissions from investment management, administrative and advisory services primarily for individuals, and to a lesser extent, partnerships and corporations. Revenue is recognized on an accrual basis at the time the services are performed and when we have a right to invoice and are based on either the market value of the assets managed or the services provided.

Wealth management incomes. Wealth management income includes fees and commissions charged when we arrange for another party to transfer brokerage services to a customer. The fees and commissions under this agent relationship are based upon stated fee schedules based upon the type of transaction, volume, and value of the services provided.

Other noninterest income. Other noninterest income includes, among other things, merchant services income. Merchant services revenue is derived from a third party vendor that processes credit card transactions on behalf of our merchant customers. Merchant services revenue is primarily comprised of residual fee income based on the referred merchant's processing volumes and/or margin.

Recent accounting standards:

In June 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2018-07 "Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting." These amendments expand the scope of Topic 718, Compensation - Stock Compensation (which currently only includes share-based payments to employees) to include share-based payments issued to nonemployees for goods or services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. The ASU supersedes Subtopic 505-50, Equity - Equity-Based Payments to Non-Employees. The guidance is effective for public companies for fiscal years, and interim fiscal periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, but no earlier than a company's adoption date of Topic 606, Revenue from Contracts with Customers. The Company is assessing ASU 2018-07 and does not expect it to have a material impact on its accounting and disclosures.

In March 2018, the FASB issued ASU 2018-05 “Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin (SAB) No. 118.” These amendments add SEC guidance to the FASB Accounting Standards Codification regarding the Tax Cuts and Jobs Act pursuant to the issuance of SAB 118. The amendments are effective upon addition to the FASB Codification.

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company’s consolidated financial statements and related disclosures as the Company’s primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company’s revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and gains/losses on the sale of other real estate owned, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments – Overall.” The guidance in this ASU among other things, (1) requires equity investments with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (3) eliminates the requirement for public businesses entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (4) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (5) requires an entity to present separately in other comprehensive income the portion of the change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. ASU 2016-01 was effective for the Company on January 1, 2018 and resulted in a reclassification adjustment of $2 to accumulated other comprehensive income related to a gain on equity securities owned, as well as the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 7 – Fair Value Accounting for further information regarding the valuation of these loans.

In February 2016, the FASB issued ASU No. 2016-02, “Leases”. From the lessee's perspective, the new standard establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessess. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early application of this ASU is permitted for all entities. Adoption of ASU 2016-02 is not expected to have a material impact on the Company’s consolidated financial statements. The Company leases certain properties under operating leases that will result in the recognition of lease assets and lease liabilities on the Company’s consolidated balance sheet under the ASU. At June 30, 2018, the Company had contractual future minimum lease commitments of approximately $3.1 million, before considering renewal options that are generally present.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." This ASU will have a significant impact on the Company's calculation and accounting for its Allowance for Loan Losses as well as credit losses related to investment securities available-for-sale. A summary of significant provisions of this ASU is as follows:

The ASU requires that a financial asset (or a group of financial assets) measured at amortized cost basis be presented, net of a valuation allowance for credit losses, at an amount expected to be collected on the financial asset(s), and that the income statement include the measurement of credit losses for newly recognized financial assets as well as changes in expected losses on previously recognized financial assets. The provisions of this ASU require measurement of expected credit losses based on relevant information including past events, historical experience, current conditions, and reasonable and supportive forecasts that affect the collectability of the asset. The provisions of this ASU differ from current GAAP in that current GAAP generally delays recognition of the full amount of credit losses until the loss is probable of occurring.

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

The amendments in the ASU retain many of the disclosure requirements related to credit quality in current GAAP, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. In addition, the ASU requires that disclosure of credit quality indicators in relation to the amortized cost of financing receivables, a current requirement, be further disaggregated by year of origination. This ASU requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down, and limits the amount of the allowance for credit losses to the amount by which the fair value is below amortized cost. For purchased investment securities available-for-sale with a more-than-insignificant amount of credit deterioration since origination, the ASU requires an allowance be determined in a manner similar to other investment securities available-for-sale; however, the initial allowance would be added to the purchase price, with only subsequent changes in the allowance recorded in credit loss expense, and interest income recognized at the effective rate excluding the discount embedded in the purchase price related to estimated credit losses at acquisition.

This ASU will be effective for the Company for interim and annual periods beginning in the first quarter of 2020. Earlier adoption is permitted beginning in the first quarter of 2019. The Company will record the effect of implementing this ASU through a cumulative-effect adjustment through retained earnings as of the beginning of the reporting period in which Topic 326 is effective.

We are evaluating the impact of the ASU on our consolidated financial statements. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

In August of 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230) –Classification of Certain Cash Receipts and Cash Payments." This ASU is intended to reduce the diversity in practice around how certain transactions are classified within the statement of cash flows. ASU 2016-15 is effective for public companies for annual periods beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted with retrospective application. The Company adopted ASU 2016-15 on January 1, 2018 and did not have a significant impact on its consolidated statement of cash flows.

In January 2017, the FASB issued ASU 2017-04, "Intangibles – Goodwill and Other (Topic 350)" to simplify the accounting for goodwill impairment. This guidance, among other things, removes step 2 of the goodwill impairment test thus eliminating the need to determine the fair value of individual assets and liabilities of the reporting unit. Upon adoption of this ASU, goodwill impairment will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. This may result in more or less impairment being recognized than under current guidance. This Update will become effective for the Company's annual and interim goodwill impairment tests beginning in the first quarter of 2020. Adoption of this update is not expected to have a material effect on the Company’s consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.” Under the new guidance, employers will present the service cost component of the net periodic benefit cost in the same income statement line item (e.g., Salaries and Benefits) as other employee compensation costs arising from services rendered during the period. In addition, only the service cost component will be eligible for capitalization in assets. Employers will present the other components separately (e.g., Other Noninterest Expense) from the line item that includes the service cost. ASU No. 2017-07 is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption was permitted. Employers will apply the guidance on the presentation of the components of net periodic benefit cost in the income statement retrospectively. The guidance limiting the capitalization of net periodic benefit cost in assets to the service cost component will be applied prospectively. The Company adopted ASU 2017-07 on January 1, 2018, and did not have a significant impact on the Company’s consolidated financial statements.

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

2. Other comprehensive loss:

The components of other comprehensive loss and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive loss included in the Consolidated Balance Sheets relates to net unrealized gains and losses on investment securities available-for-sale and benefit plan adjustments.

The components of accumulated other comprehensive loss included in stockholders' equity at June 30, 2018 and December 31, 2017 is as follows:

	June 30, 2018	December 31, 2017
Net unrealized loss on investment securities available-for-sale	$ (4,452)	$ (1,237)
Income tax	(935)	(260)
Net of income taxes	(3,517)	(977)
Benefit plan adjustments	(6,628)	(6,628)
Income tax	(1,392)	(1,392)
Net of income taxes	(5,236)	(5,236)
Accumulated other comprehensive loss	$ (8,753)	$ (6,213)

Other comprehensive income (loss) and related tax effects for the three and six months ended June 30, 2018 and 2017 is as follows:

Three Months Ended June 30,	2018	2017
Unrealized (loss) gain on investment securities available-for-sale	$ (839)	$ 1,184
Net gain on the sale of investment securities available-for-sale		
Other comprehensive (loss) gain before taxes	(839)	1,184
Income tax	(176)	415
Other comprehensive (loss) income	$ (663)	$ 769

Six Months Ended June 30,	2018	2017
Unrealized (loss) gain on investment securities available-for-sale	$ (3,215)	$ 1,457
Net gain on the sale of investment securities available-for-sale		
Other comprehensive loss before taxes	(3,215)	1,457
Income tax	(677)	510
Other comprehensive (loss) income	$ (2,538)	$ 947

3. Earnings per share:

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

There were no shares considered anti-dilutive for the three and six month periods ended June 30, 2018 and 2017.

	2018		2017	
For the Three Months Ended June 30,	Basic	Diluted	Basic	Diluted
Net Income	$ 5,957	$ 5,957	$ 5,659	$ 5,659
Average common shares outstanding	7,396,533	7,396,533	7,396,163	7,396,163
Earnings per share	$ 0.81	$ 0.81	$ 0.76	$ 0.76

	2018		2017	
For the Six Months Ended June 30	Basic	Diluted	Basic	Diluted
Net Income	$ 11,811	$ 11,811	$ 10,459	$ 10,459
Average common shares outstanding	7,396,519	7,396,519	7,395,158	7,395,158
Earnings per share	$ 1.60	$ 1.60	$ 1.41	$ 1.41

4. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at June 30, 2018 and December 31, 2017 are summarized as follows:

June 30, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	$ 25,934		$ 587	$ 25,347
U.S. Government-sponsored enterprises	95,179		3,131	92,048
State and municipals:				
Taxable	13,607	$ 302		13,909
Tax-exempt	95,220	736	822	95,134
Residential Mortgage-backed securities:				
U.S. Government agencies	15,809		109	15,700

U.S. Government-sponsored enterprises	27,461	1	523	26,939
Commercial Mortgage-backed securities:				
U.S. Government-sponsored enterprises	6,292		319	5,973
Total	$ 279,502	$ 1,039	$ 5,491	$ 275,050
Held-to-maturity:				
Tax-exempt state and municipals	$ 6,857	$ 6	$ 109	$ 6,754
Residential Mortgage-backed securities:				
U.S. Government agencies	48	1		49
U.S. Government-sponsored enterprises	1,875	84	4	1,955
Total	$ 8,780	$ 91	$ 113	$ 8,758

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December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	$ 20,042		$ 228	$ 19,814
U.S. Government-sponsored enterprises	95,358	$ 30	1,740	93,648
State and municipals:				
Taxable	14,559	488		15,047
Tax-exempt	103,199	1,136	502	103,833
Residential Mortgage-backed securities:				
U.S. Government agencies	14,517	2	85	14,434
U.S. Government-sponsored enterprises	19,752	10	231	19,531
Commercial Mortgage-backed securities:				
U.S. Government-sponsored enterprises	6,315		120	6,195
Total	$ 273,742	$ 1,666	$ 2,906	$ 272,502
Held-to-maturity:				
Tax-exempt state and municipals	$ 6,859	$ 152	$ 13	$ 6,998
Residential Mortgage-backed securities:				
U.S. Government agencies	54			54
U.S. Government-sponsored enterprises	2,361	138	4	2,495
Total	$ 9,274	$ 290	$ 17	$ 9,547

Equity Securities

Our equity securities portfolio consists of stock of two other financial institutions. At June 30, 2018 and December 31, 2017, we had $278 thousand and $46 thousand, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of AOCI, net of tax. At December 31, 2017, net unrealized gains of $2 thousand had been recognized in Accumulated Other Comprehensive Income (“AOCI”). On January 1, 2018, these unrealized gains, net of income tax were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income. At June 30, 2018, the fair value of our equity portfolio was equal to our cost basis. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three and six months ended June 30, 2018 (in thousands):

June 30, 2018	Three months ended June 30, 2018	Six months ended June 30, 2018
Net gains and (losses) recognized during the period on equity securities	$ 8	$
Less: Net gains and (losses) recognized during the period on equity securities sold during the period		
Unrealized gains and (losses) recognized during the reporting period on equity securities still held at the reporting date	$ 8	$

Restricted Investment In Stock

Restricted investment in stock includes Federal Home Loan Bank of Pittsburgh ("FHLB") with a carrying cost of $11,314 and $8,520 at June 30, 2018 and December 31, 2017, respectively and Atlantic Community Bankers Bank ("ACBB") stock with a carrying cost of $42 and VISA Class B stock with a carry cost of $0 at June 30, 2018 and December 31, 2017, are included in other assets in the consolidated balance sheets. FHLB and ACBB stock was issued as a requirement to facilitate participation in borrowing and other banking services. The investment in FHLB stock may fluctuate, as it is based on the member banks' use of FHLB's services.

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Peoples Bank owns 44,982 shares of Visa Class B stock, which was necessary to participate in Visa services in support of the Bank's credit card, debit card, and related payment programs (permissible activities under banking regulations) as a member institution. Following the resolution of Visa's covered litigation, shares of Visa's Class B stock will be converted to Visa Class A shares using a conversion factor (1.6298 as of June 30, 2018), which is periodically adjusted to reflect VISA's ongoing litigation costs. There is a very limited market for this stock, as only current owners of Class B shares are permitted to transact in Class B. Due to the lack of orderly trades and public information of such trades, Visa Class B's is difficult to value.

These restricted investments are carried at cost and evaluated for other-than-temporary impairment ("OTTI") periodically. As of June 30, 2018, there was no OTTI associated with these investments.

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at June 30, 2018, is summarized as follows:

June 30, 2018	Fair Value
Within one year	$ 22,297
After one but within five years	172,695
After five but within ten years	17,531
After ten years	13,915
	226,438
Mortgage-backed securities	48,612
Total	$ 275,050

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at June 30, 2018, is summarized as follows:

June 30, 2018	Amortized Cost	Fair Value
Within one year		

After one but within five years		
After five but within ten years		
After ten years	$ 6,857	$ 6,754
	6,857	6,754
Mortgage-backed securities	1,923	2,004
Total	$ 8,780	$ 8,758

Securities with a carrying value of $153,587 and $163,936 at June 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits and certain other deposits as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty's creditworthiness and type of collateral is evaluated on a case-by-case basis. At June 30, 2018 and December 31, 2017, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. Government agencies and sponsored enterprises, that exceeded 10.0 percent of stockholders' equity.

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The fair value and gross unrealized losses of investment securities with unrealized losses for which an OTTI has not been recognized at June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

	Less Than 12 Months		12 Months or More		Total	
June 30, 2018	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities	$ 22,935	$ 479	$ 2,412	$ 108	$ 25,347	$ 587
U.S. Government-sponsored enterprises	41,517	1,142	50,531	1,989	92,048	3,131
State and municipals:						
Tax-exempt	61,299	820	3,956	111	65,255	931
Residential Mortgage-backed securities:						
U.S. Government agencies	11,211	44	4,328	65	15,539	109
U.S. Government-sponsored enterprises	20,761	367	6,062	160	26,823	527
Commercial Mortgage-backed securities:						
U.S. Government-sponsored enterprises	5,973	319			5,973	319
Total	$ 163,696	$ 3,171	$ 67,289	$ 2,433	$ 230,985	$ 5,604

	Less Than 12 Months		12 Months or More		Total	
December 31, 2017	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities	$ 17,350	$ 170	$ 2,464	$ 58	$ 19,814	$ 228
U.S. Government-sponsored enterprises	39,096	445	51,365	1,295	90,461	1,740
State and municipals:						
Tax-exempt	54,788	454	3,808	61	58,596	515
Residential Mortgage-backed securities:						
U.S. Government agencies	9,484	39	3,968	46	13,452	85

U.S. Government-sponsored enterprises	12,537	103	6,504	132	19,041	235
Commercial						
Mortgage-backed securities:						
U.S. Government-sponsored enterprises	6,195	120			6,195	120
Total	$ 139,450	$ 1,331	$ 68,109	$ 1,592	$ 207,559	$ 2,923

The Company had 204 investment securities, consisting of 112 tax-exempt state and municipal obligations, nine U.S. Treasury securities, 38 U.S. Government-sponsored enterprise securities, and 45 mortgage-backed securities that were in unrealized loss positions at June 30, 2018. Of these securities, one U.S. Treasury security, 20 U.S. Government-sponsored enterprise securities, eight tax-exempt state and municipal obligations, and 19 mortgage-backed securities were in a continuous unrealized loss position for twelve months or more. Management does not consider the unrealized losses on the debt securities, as a result of changes in interest rates, to be OTTI based on historical evidence that indicates the cost of these securities is recoverable within a reasonable period of time in relation to normal cyclical changes in the market rates of interest. Moreover, because there has been no material change in the credit quality of the issuers or other events or circumstances that may cause a significant adverse impact on the fair value of these securities, and management does not intend to sell these securities and it is unlikely that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be maturity, the Company does not consider the unrealized losses to be OTTI at June 30, 2018. There was no OTTI recognized for the three or six months ended June 30, 2018 and 2017.

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5. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at June 30, 2018 and December 31, 2017 are summarized as follows. Net deferred loan costs were $782 and $575 at June 30, 2018 and December 31, 2017.

	June 30, 2018	December 31, 2017
Commercial	$ 469,318	$ 476,199
Real estate:		
Commercial	867,349	786,210
Residential	290,831	287,935
Consumer	125,891	142,721
Total	$ 1,753,389	$ 1,693,065

The changes in the allowance for loan losses account by major classification of loan for the three and six months ended June 30, 2018 and 2017 are summarized as follows:

June 30, 2018	Commercial	Real estate Commercial	Residential	Consumer	Total
Allowance for loan losses:					
Beginning Balance April 1, 2018	$ 5,406	$ 8,099	$ 4,839	$ 1,374	$ 19,718
Charge-offs	(2)	(1,169)	(82)	(145)	(1,398)
Recoveries	59	30	57	57	203
Provisions	286	546	148	70	1,050
Ending balance	$ 5,749	$ 7,506	$ 4,962	$ 1,356	$ 19,573

June 30, 2017	Commercial	Real estate Commercial	Residential	Consumer	Total
Allowance for loan losses:					
Beginning Balance April 1, 2017	$ 4,129	$ 6,291	$ 4,978	$ 1,571	$ 16,969
Charge-offs	(32)	(242)	(8)	(149)	(431)
Recoveries	6	22	4	32	64

Provisions	323	516	222	139	1,200
Ending balance	$ 4,426	$ 6,587	$ 5,196	$ 1,593	$ 17,802

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June 30, 2018	Commercial	Real estate Commercial	Residential	Consumer	Total
Allowance for loan losses:					
Beginning Balance January 1, 2018	$ 5,052	$ 7,548	$ 4,980	1,380	18,960
Charge-offs	(2)	(1,169)	(381)	(272)	(1,824)
Recoveries	116	57	67	97	337
Provisions	583	1,070	296	151	2,100
Ending balance	$ 5,749	$ 7,506	$ 4,962	$ 1,356	$ 19,573

June 30, 2017	Commercial	Real estate Commercial	Residential	Consumer	Total
Allowance for loan losses:					
Beginning Balance January 1, 2017	$ 3,799	$ 5,847	$ 4,707	$ 1,608	$ 15,961
Charge-offs	(32)	(367)	(23)	(320)	(742)
Recoveries	13	55	26	89	183
Provisions	646	1,052	486	216	2,400
Ending balance	$ 4,426	$ 6,587	$ 5,196	$ 1,593	$ 17,802

The allocation of the allowance for loan losses and the related loans by major classifications of loans at June 30, 2018 and December 31, 2017 is summarized as follows:

June 30, 2018	Commercial	Real estate Commercial	Residential	Consumer	Total
Allowance for loan losses:					
Ending balance	$ 5,749	$ 7,506	$ 4,962	$ 1,356	$ 19,573
Ending balance: individually evaluated for impairment	146	502	378	3	1,029
Ending balance: collectively evaluated for impairment	5,603	7,004	4,584	1,353	18,544
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$
Loans receivable:					

Ending balance	$ 469,318	$ 867,349	$ 290,831	$ 125,891	$ 1,753,389
Ending balance: individually evaluated for impairment	1,972	4,060	3,542	63	9,637
Ending balance: collectively evaluated for impairment	467,035	862,723	287,261	125,828	1,742,847
Ending balance: loans acquired with deteriorated credit quality	$ 311	$ 566	$ 28	$	$ 905

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December 31, 2017	Commercial	Real estate Commercial	Residential	Consumer	Total
Allowance for loan losses:					
Ending balance	$ 5,052	$ 7,548	$ 4,980	$ 1,380	$ 18,960
Ending balance: individually evaluated for impairment	159	263	336	8	766
Ending balance: collectively evaluated for impairment	4,893	7,285	4,644	1,372	18,194
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$
Loans receivable:					
Ending balance	$ 476,199	$ 786,210	$ 287,935	$ 142,721	$ 1,693,065
Ending balance: individually evaluated for impairment	2,121	3,644	3,763	177	9,705
Ending balance: collectively evaluated for impairment	473,736	781,921	284,142	142,544	1,682,343
Ending balance: loans acquired with deteriorated credit quality	$ 342	$ 645	$ 30	$	$ 1,017

The Company segments loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are individually analyzed for credit risk by classifying them within the Company's internal risk rating system. The Company's risk rating classifications are defined as follows:

· Pass- A loan to borrowers with acceptable credit quality and risk that is not adversely classified as Substandard, Doubtful, Loss nor designated as Special Mention.

· Special Mention- A loan that has potential weaknesses that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the institution's credit position at some future date. Special Mention loans are not adversely classified since they do not expose the Company to sufficient risk to warrant adverse classification.

· Substandard- A loan that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

· Doubtful – A loan classified as Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

· Loss- A loan classified as Loss is considered uncollectible and of such little value that its continuance as bankable loan is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

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The following tables present the major classification of loans summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system at June 30, 2018 and December 31, 2017:

June 30, 2018	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 465,880	$ 627	$ 2,811	$	$ 469,318
Real estate:					
Commercial	842,115	12,916	12,318		867,349
Residential	285,388	17	5,426		290,831
Consumer	125,804		87		125,891
Total	$ 1,719,187	$ 13,560	$ 20,642	$	$ 1,753,389

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 472,185	$ 1,958	$ 2,056	$	$ 476,199
Real estate:					
Commercial	764,320	13,015	8,875		786,210
Residential	282,484	18	5,433		287,935
Consumer	142,507		214		142,721
Total	$ 1,661,496	$ 14,991	$ 16,578	$	$ 1,693,065

Information concerning nonaccrual loans by major loan classification at June 30, 2018 and December 31, 2017 is summarized as follows:

	June 30, 2018	December 31, 2017
Commercial	$ 760	$ 860
Real estate:		
Commercial	3,824	3,821
Residential	2,890	2,994
Consumer	63	177
Total	$ 7,537	$ 7,852

The major classifications of loans by past due status are summarized as follows:

June 30, 2018	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Loans > 90 Days and Accruing
Commercial	$ 817	$ 13	$ 760	$ 1,590	$ 467,728	$ 469,318	
Real estate:							
Commercial	2,174	988	3,824	6,986	860,363	867,349	
Residential	1,659	812	2,962	5,433	285,398	290,831	$ 72
Consumer	582	219	75	876	125,015	125,891	12
Total	$ 5,232	$ 2,032	$ 7,621	$ 14,885	$ 1,738,504	$ 1,753,389	$ 84

The Company classifies all nonaccrual loans in the greater than 90 days category.

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December 31, 2017	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Loans > 90 Days and Accruing
Commercial	$ 124	$ 216	$ 860	$ 1,200	$ 474,999	$ 476,199	
Real estate:							
Commercial	1,722	194	3,821	5,737	780,473	786,210	
Residential	1,134	1,551	3,543	6,228	281,707	287,935	$ 549
Consumer	1,101	364	363	1,828	140,893		