

ACNB CORP  
Form 10-Q  
November 03, 2017

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended September 30, 2017**

**Commission file number 1-35015**

**ACNB CORPORATION**

**(Exact name of Registrant as specified in its charter)**

**Pennsylvania**  
**(State or other jurisdiction of  
incorporation or organization)**

**23-2233457**  
**(I.R.S. Employer  
Identification No.)**

**16 Lincoln Square, Gettysburg, Pennsylvania**  
**(Address of principal executive offices)**

**17325**  
**(Zip Code)**

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

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**Title of each class**  
Common Stock, \$2.50 par value per share

**Name of each exchange on which registered**  
The NASDAQ Stock Market, LLC

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

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

Indicate by check mark 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 ☐

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 ☒

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

## PART I - FINANCIAL INFORMATION

## ACNB CORPORATION

## ITEM 1 - FINANCIAL STATEMENTS

## CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

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

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outstanding

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

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

## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

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

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

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

## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

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

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

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

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

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

## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

Nine Months Ended September 30, 2017 and 2016

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

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



## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

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

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

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

**ACNB CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation and Nature of Operations**

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

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

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

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

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

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

The Corporation has evaluated events and transactions occurring subsequent to the statement of condition date of September 30, 2017, for items that should potentially be recognized or disclosed in the consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

2. **Acquisition of New Windsor Bancorp, Inc.**

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

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

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

### Purchase Price Consideration in Common Stock

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

### Allocation of Purchase Price

In thousands

<b>Total Purchase Price</b>	\$	33,290
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### Fair Value of Assets Acquired

Cash and cash equivalents	10,964
Investment securities	21,624
Loans held for sale	1,463
Loans	263,450
Restricted stock	486
Premises and equipment	8,624
Core deposit intangible asset	2,418
Other assets	10,792
<b>Total assets</b>	<b>319,821</b>

### Fair Value of Liabilities Assumed

Non-interest bearing deposits	80,006
Interest bearing deposits	213,327
Subordinated debt	4,688
Other liabilities	1,782
<b>Total liabilities</b>	<b>299,803</b>

<b>Net Assets Acquired</b>	<b>20,018</b>
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<b>Goodwill Recorded in Merger</b>	<b>\$ 13,272</b>
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Pursuant to the accounting requirements, the Corporation assigned a fair value to the assets acquired and liabilities assumed of NW Bancorp. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.



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

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

#### Investment securities available-for-sale

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

#### Loans

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

#### In thousands

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

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

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



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

**In thousands**

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

**Bank Premises**

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

**Core Deposit Intangible**

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

**Time Deposits**

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

**Long-term Borrowings**

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

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

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

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

### 3. Earnings Per Share and Restricted Stock Plan

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

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

### 4. Retirement Benefits

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

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

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

### 5. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit

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is essentially the same as those that are involved in extending loan facilities to customers. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had \$6,974,000 in standby letters of credit as of September 30, 2017. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability, as of September 30, 2017, for guarantees under standby letters of credit issued is not material.

## 6. Accumulated Other Comprehensive Loss

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

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

## 7. Segment Reporting

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

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

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

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

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

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

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

8. **Securities**

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

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

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

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



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

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

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

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

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



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

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

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

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

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

The fair values of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2) which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the security's relationship to other benchmark quoted prices. The Corporation uses independent service providers to provide matrix pricing.

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

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

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

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

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

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

## 9. **Loans**

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

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

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

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

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

### **Allowance for Credit Losses**

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

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

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

- lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;
- national, regional and local economic and business conditions, as well as the condition of various market segments, including the impact on the value of underlying collateral for collateral dependent loans;
- the nature and volume of the portfolio and terms of loans;
- the experience, ability and depth of lending management and staff;
- the volume and severity of past due, classified and nonaccrual loans, as well as other loan modifications; and,

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

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

The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. It covers risks that are inherently difficult to quantify including, but not limited to, collateral risk, information risk, and historical charge-off risk.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal and/or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and/or interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and commercial construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

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

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

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

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



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

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

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

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

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

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

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

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum values have been established by the Corporation and are specific to the

type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, collateral appraisals, etc.

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

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

**Commercial Real Estate Lending** The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation's commercial loan portfolio is secured primarily by commercial retail space, office buildings, and hotels. Generally, commercial real estate loans have terms that do not exceed 20 years, have loan-to-value ratios of up to 80% of the appraised value of the property, and are typically secured by personal guarantees of the borrowers.

In underwriting these loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. Appraisals on properties securing commercial real estate loans originated by the Corporation are performed by independent appraisers.

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

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

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

In underwriting commercial real estate construction loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the project using feasibility studies, market data, etc. Appraisals on properties securing commercial real estate construction loans originated by the Corporation are performed by independent appraisers.

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

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

The Corporation offers fixed-rate and adjustable-rate mortgage loans with terms up to a maximum of 30 years for both permanent structures and those under construction. The Corporation's one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The majority of the Corporation's residential mortgage loans originate with a loan-to-value of 80% or less. Loans in excess of 80% are required to have private mortgage insurance.

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

in subprime residential mortgage originations.

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

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

Home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of 90% and a maximum term of 20 years. In underwriting home equity lines of credit, the Corporation evaluates both the value of the property securing the loan and the borrower's financial ability to repay the loan as agreed. The ability to repay is determined by the borrower's employment history, current financial condition, and credit background.

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

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

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

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

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

### **Acquired Loans**

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

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

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

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

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

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

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

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

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

In thousands	Pass	Special Mention	Substandard	Doubtful	Total
<b>SEPTEMBER 30, 2017</b>					
<b>Originated Loans</b>					
Commercial and industrial	\$ 157,249	\$ 3,348	\$ 2,060	\$	\$ 162,657
Commercial real estate	312,432	19,134	9,355		340,921
Commercial real estate construction	31,042	1,009	250		32,301
Residential mortgage	352,238	3,895	544		356,677
Home equity lines of credit	77,486	352	90		77,928
Consumer	14,413				14,413
<b>Total Originated Loans</b>	<b>944,860</b>	<b>27,738</b>	<b>12,299</b>		<b>984,897</b>
<b>Acquired Loans</b>					
Commercial and industrial	6,123	177	80		6,380
Commercial real estate	125,703	13,824	3,225		142,752
Commercial real estate construction	7,085	393			7,478
Residential mortgage	58,927	2,932	3,196		65,055
Home equity lines of credit	26,726	88	371		27,185
Consumer	2,263	358	2		2,623
<b>Total Acquired Loans</b>	<b>226,827</b>	<b>17,772</b>	<b>6,874</b>		<b>251,473</b>
<b>Total Loans</b>					
Commercial and industrial	163,372	3,525	2,140		169,037
Commercial real estate	438,135	32,958	12,580		483,673
Commercial real estate construction	38,127	1,402	250		39,779
Residential mortgage	411,165	6,827	3,740		421,732
Home equity lines of credit	104,212	440	461		105,113
Consumer	16,676	358	2		17,036
<b>Total Loans</b>	<b>\$ 1,171,687</b>	<b>\$ 45,510</b>	<b>\$ 19,173</b>	<b>\$</b>	<b>\$ 1,236,370</b>
<b>DECEMBER 31, 2016</b>					
Commercial and industrial	\$ 134,088	\$ 2,355	\$ 3,901	\$	\$ 140,344
Commercial real estate	291,762	17,376	9,842		318,980
Commercial real estate construction	13,606	1,202	463		15,271
Residential mortgage	344,048	3,617	874		348,539
Home equity lines of credit	69,190	756	126		70,072
Consumer	14,704				14,704
	\$ 867,398	\$ 25,306	\$ 15,206	\$	\$ 907,910



The following table provides changes in accretable yield for all acquired loans accounted for under ASC 310-30. Loans accounted for under ASC 310-20 are not included in this table.

<b>In thousands</b>	<b>Nine Months Ended September 30, 2017</b>	
Balance at beginning of period	\$	
Acquisitions of impaired loans		<b>1,458</b>
Reclassification from non-accretable differences		
Accretion		<b>(111)</b>
Balance at end of period	\$	<b>1,347</b>

Cash flows expected to be collected on acquired loans are estimated quarterly by incorporating several key assumptions similar to the initial estimate of fair value. These key assumptions include probability of default and the amount of actual prepayments after the acquisition date. Prepayments affect the estimated life of the loans and could change the amount of interest income, and possibly principal expected to be collected. In reforecasting future estimated cash flows, credit loss expectations are adjusted as necessary. Improved cash flow expectations for loans or pools are recorded first as a reversal of previously recorded impairment, if any, and then as an increase in prospective yield when all previously recorded impairment has been recaptured. Decreases in expected cash flows are recognized as impairment through a charge to the provision for loan losses and credit to the allowance for loan losses.

The following table summarizes information relative to impaired loans by loan portfolio class as of September 30, 2017, and December 31, 2016:

<b>In thousands</b>	<b>Impaired Loans with Allowance Unpaid</b>			<b>Impaired Loans with No Allowance Unpaid</b>		
	<b>Recorded Investment</b>	<b>Principal Balance</b>	<b>Related Allowance</b>	<b>Recorded Investment</b>	<b>Principal Balance</b>	
<b>SEPTEMBER 30, 2017</b>						
Commercial and industrial	\$ 1,353	\$ 1,353	\$ 698	\$ 390	\$ 390	
Commercial real estate	832	832	117	7,581	7,581	
Residential mortgage	377	377	377	101	101	
	\$ 2,562	\$ 2,562	\$ 1,192	\$ 8,072	\$ 8,072	
<b>DECEMBER 31, 2016</b>						
Commercial and industrial	\$ 948	\$ 948	\$ 599	\$ 1,178	\$ 1,178	
Commercial real estate				8,764	8,965	
Commercial real estate construction				300	300	
Residential mortgage	376	376	333	379	379	
	\$ 1,324	\$ 1,324	\$ 932	\$ 10,621	\$ 10,822	

The following table summarizes information in regards to the average of impaired loans and related interest income by loan portfolio class for the three months ended September 30, 2017 and 2016:

In thousands	Impaired Loans with Allowance		Impaired Loans with No Allowance	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
<b>SEPTEMBER 30, 2017</b>				
Commercial and industrial	\$ 1,360	\$	\$ 734	\$
Commercial real estate	832		7,626	80
Commercial real estate construction				
Residential mortgage	378		101	
	\$ 2,570	\$	\$ 8,461	\$ 80
<b>SEPTEMBER 30, 2016</b>				
Commercial and industrial	\$	\$	1,361	\$ 3
Commercial real estate			8,156	104
Commercial real estate construction			300	
Residential mortgage	374		414	4
	\$ 374	\$	\$ 10,231	\$ 111

The following table summarizes information in regards to the average of impaired loans and related interest income by loan portfolio class for the nine months ended September 30, 2017 and 2016:

In thousands	Impaired Loans with Allowance		Impaired Loans with No Allowance	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
<b>SEPTEMBER 30, 2017</b>				
Commercial and industrial	\$ 1,152	\$	\$ 934	\$
Commercial real estate	416		8,155	293
Commercial real estate construction			75	25
Residential mortgage	377		238	15
	\$ 1,945	\$	\$ 9,402	\$ 333
<b>SEPTEMBER 30, 2016</b>				
Commercial and industrial	\$	\$	1,400	\$ 3
Commercial real estate			8,280	327
Commercial real estate construction			337	
Residential mortgage	187		435	13
	\$ 187	\$	\$ 10,452	\$ 343

No additional funds are committed to be advanced in connection with impaired loans.

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The following table presents nonaccrual loans by loan portfolio class as of September 30, 2017, and December 31, 2016, the table below excludes \$6.9 million in purchase credit impaired loans, net of unamortized fair value adjustments:

In thousands	September 30, 2017	December 31, 2016
Commercial and industrial	\$ 1,743	\$ 2,126
Commercial real estate	4,474	1,593
Commercial real estate construction		300
Residential mortgage	478	483
	\$ 6,695	\$ 4,502

The following table summarizes information relative to troubled debt restructurings by loan portfolio class as of September 30, 2017, and December 31, 2016:

In thousands	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Recorded Investment at Period End
<b>SEPTEMBER 30, 2017</b>			
Nonaccruing troubled debt restructurings:			
Commercial real estate	\$ 4,015	\$ 4,073	\$ 3,434
Total nonaccruing troubled debt restructurings	4,015	4,073	3,434
Accruing troubled debt restructurings:			
Commercial real estate	4,577	4,577	3,939
Total accruing troubled debt restructurings	4,577	4,577	3,939
<b>Total Troubled Debt Restructurings</b>	<b>\$ 8,592</b>	<b>\$ 8,650</b>	<b>\$ 7,373</b>
<b>DECEMBER 31, 2016</b>			
Nonaccruing troubled debt restructurings:			
Commercial real estate	\$ 648	\$ 648	\$ 377
Total nonaccruing troubled debt restructurings	648	648	377
Accruing troubled debt restructurings:			
Commercial real estate	7,944	8,002	7,171
Residential mortgage	336	336	272
Total accruing troubled debt restructurings	8,280	8,338	7,443
<b>Total Troubled Debt Restructurings</b>	<b>\$ 8,928</b>	<b>\$ 8,986</b>	<b>\$ 7,820</b>

All of the Corporation's troubled debt restructured loans are also impaired loans, of which some have resulted in a specific allocation and, subsequently, a charge-off as appropriate. As of September 30, 2017 and 2016, there were no defaulted troubled debt restructured loans, however two borrowers advised that further payments were unlikely, therefore they were moved to nonaccrual status in the second quarter of 2017. There were no charge-offs or specific allocation on any of the troubled debt restructured loans for the three and nine months ended September 30, 2017 and 2016. One troubled debt restructured loan paid off during 2017 in the amount of \$283,000 and one paid off during 2016 in the amount of \$74,000. All other troubled debt restructured loans were current as of September 30, 2017, with respect to their associated forbearance agreement, except for one loan which has had periodic late payments. As of September 30, 2017, only two of the loans classified as troubled debt restructured loans have active forbearance agreements. Of those, one forbearance agreement was negotiated during 2013 and the other forbearance agreement was negotiated during 2016. All other forbearance agreements have expired or the loans have paid off.

There were no loans whose terms have been modified resulting in troubled debt restructurings during the three and nine months ended September 30, 2017 and 2016. Two properties were added to nonaccrual in the second quarter of 2017. Both loans are current with their modified terms and are supported by adequate collateral.

Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process at September 30, 2017 and December 31, 2016, totaled \$1,109,000 and \$471,000, respectively.

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due.

The following table presents the classes of the loan portfolio summarized by the past due status as of September 30, 2017, and December 31, 2016:

In thousands	30-59 Days Past Due	60-89 Days Past Due	>90 Days Past Due	Total Past Due	Current	Total Loans Receivable	Loans Receivable >90 Days and Accruing
<b>SEPTEMBER 30, 2017</b>							
<b>Originated Loans</b>							
Commercial and industrial	\$ 75	\$ 1	\$ 1,749	\$ 1,825	\$ 160,832	\$ 162,657	\$ 6
Commercial real estate			1,313	1,313	339,608	340,921	
Commercial real estate construction		332		332	31,969	32,301	
Residential mortgage	397	363	1,977	2,737	353,940	356,677	1,499
Home equity lines of credit	105	50	96	251	77,677	77,928	96
Consumer	65	3		68	14,345	14,413	
<b>Total originated loans</b>	<b>642</b>	<b>749</b>	<b>5,135</b>	<b>6,526</b>	<b>978,371</b>	<b>984,897</b>	<b>1,601</b>
<b>Acquired Loans</b>							
Commercial and industrial		1		1	6,379	6,380	
Commercial real estate					142,752	142,752	
Commercial real estate construction	76			76	7,402	7,478	
Residential mortgage	298	115	25	438	64,617	65,055	25
Home equity lines of credit	605			605	26,580	27,185	
Consumer	12			12	2,611	2,623	
<b>Total acquired loans</b>	<b>991</b>	<b>116</b>	<b>25</b>	<b>1,132</b>	<b>250,341</b>	<b>251,473</b>	<b>25</b>
<b>Total Loans</b>							
Commercial and industrial	75	2	1,749	1,826	167,211	169,037	6
Commercial real estate			1,313	1,313	482,360	483,673	
Commercial real estate construction	76	332		408	39,371	39,779	
Residential mortgage	695	478	2,002	3,175	418,557	421,732	1,524
Home equity lines of credit	710	50	96	856	104,257	105,113	96
Consumer	77	3		80	16,956	17,036	
<b>Total Loans</b>	<b>\$ 1,633</b>	<b>\$ 865</b>	<b>\$ 5,160</b>	<b>\$ 7,658</b>	<b>\$ 1,228,712</b>	<b>\$ 1,236,370</b>	<b>\$ 1,626</b>
<b>DECEMBER 31, 2016</b>							
Commercial and industrial	\$ 26	\$ 1	\$ 1,178	\$ 1,205	\$ 139,139	\$ 140,344	\$
Commercial real estate	325	674		999	317,981	318,980	
Commercial real estate construction			300	300	14,971	15,271	
Residential mortgage	2,866	657	1,413	4,936	343,603	348,539	937
Home equity lines of credit	310	56	408	774	69,298	70,072	408
Consumer	31	47		78	14,626	14,704	
<b>Total loans</b>	<b>\$ 3,558</b>	<b>\$ 1,435</b>	<b>\$ 3,299</b>	<b>\$ 8,292</b>	<b>\$ 899,618</b>	<b>\$ 907,910</b>	<b>\$ 1,345</b>

The following tables summarize the allowance for loan losses and recorded investment in loans receivable:

AS OF AND FOR THE PERIOD ENDED SEPTEMBER 30, 2017																
Beginning balance - July 1, 2017	\$	3,246	\$	5,210	\$	135	\$	3,368	\$	607	\$	815	\$	767	\$	14,148
Recoveries		8				40		10				1				59
Ending balance - September 30, 2017	\$	3,267	\$	5,405	\$	144	\$	3,262	\$	627	\$	810	\$	590	\$	14,105
Beginning balance - January 1, 2017	\$	3,055	\$	4,968	\$	147	\$	3,478	\$	648	\$	923	\$	975	\$	14,194
Recoveries		17		61		40		52				13				183
Ending balance - September 30, 2017	\$	3,267	\$	5,405	\$	144	\$	3,262	\$	627	\$	810	\$	590	\$	14,105
Ending balance: collectively evaluated for impairment	\$	2,569	\$	5,288	\$	144	\$	2,885	\$	627	\$	810	\$	590	\$	12,913
Loans Receivable																
Ending balance: individually evaluated for impairment	\$	1,743	\$	8,413	\$		\$	478	\$		\$		\$		\$	10,634
Allowance for Loan Losses																
Charge-offs		(131)						(6)				(28)				(165)
Provisions		(80)		(60)		11		(46)		2		(11)		184		
Charge-offs		(221)				(135)		(45)		(9)		(50)				(460)
Provisions		20		157		36		(51)		(1)		(127)		(34)		
Ending balance: individually evaluated for impairment	\$		\$		\$		\$	167	\$		\$		\$		\$	167

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Ending balance	\$	122,926	\$	309,161	\$	13,243	\$	346,422	\$	65,689	\$	14,582	\$	872,023
Ending balance: collectively evaluated for impairment	\$	121,677	\$	301,119	\$	12,943	\$	345,663	\$	65,689	\$	14,582	\$	861,673

**AS OF DECEMBER 31, 2016**

Ending balance	\$	3,055	\$	4,968	\$	147	\$	3,478	\$	648	\$	923	\$	975	\$	14,194
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Ending balance: collectively evaluated for impairment	\$	2,456	\$	4,968	\$	147	\$	3,145	\$	648	\$	923	\$	975	\$	13,262
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**Loans Receivable**

Ending balance: individually evaluated for impairment	\$	2,126	\$	8,764	\$	300	\$	755	\$		\$		\$		\$	11,945
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**10. Fair Value Measurements**

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective reporting dates and have not been reevaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.

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

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

Fair value measurement and disclosure guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:



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

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

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

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An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For assets measured at fair value, the fair value measurements by level within the fair value hierarchy, and the basis of measurement used, at September 30, 2017, and December 31, 2016, are as follows:

		September 30, 2017			
In thousands	Basis	Total	Level 1	Level 2	Level 3
U.S. Government and agencies		\$ 99,014	\$	\$ 99,014	\$
Mortgage-backed securities, residential		37,351		37,351	
State and municipal		15,116		15,116	
Corporate bonds		5,112		5,112	
CRA mutual fund		1,042	1,042		
Stock in other banks		757	757		
Total securities available for sale	Recurring	\$ 158,392	\$ 1,799	\$ 156,593	\$
Impaired loans	Nonrecurring	\$ 5,462	\$	\$	\$ 5,462

		December 31, 2016			
In thousands	Basis	Total	Level 1	Level 2	Level 3
U.S. Government and agencies		\$ 79,579	\$	\$ 79,579	\$
Mortgage-backed securities, residential		31,973		31,973	
State and municipal		24,660		24,660	
Corporate bonds		5,062		5,062	
CRA mutual fund		1,035	1,035		
Stock in other banks		681	681		
Total securities available for sale	Recurring	\$ 142,990	\$ 1,716	\$ 141,274	\$
Impaired loans	Nonrecurring	\$ 4,406	\$	\$	\$ 4,406

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

Dollars in thousands	Fair Value Estimate	Quantitative Information about Level 3 Fair Value Measurements			Weighted Average
		Valuation Technique	Unobservable Input	Range	
September 30, 2017					
Impaired loans	\$ 5,462	Appraisal of collateral (a)	Appraisal adjustments (b)	(10) - (50)%	(34)%
December 31, 2016					
Impaired loans	\$ 4,406	Appraisal of collateral (a)	Appraisal adjustments (b)	(10) - (50)%	(39)%

(a) Fair value is generally determined through management's estimate or independent third-party appraisals of the underlying collateral, which generally includes various Level 3 inputs which are not observable.

(b) Appraisals may be adjusted downward by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percentage of the appraisal. Higher downward adjustments are caused by negative changes to the collateral or conditions in the real estate market, actual offers or sales contracts received, and/or age of the appraisal.

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of certain Corporation financial instruments at September 30, 2017, and December 31, 2016:

### **Cash and Cash Equivalents (Carried at Cost)**

The carrying amounts reported in the consolidated statement of condition for cash and short-term instruments approximate those assets' fair value. U.S. currency is Level 1 and cash equivalents are Level 2.

### **Securities**

The fair values of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific security but rather by relying on the security's relationship to other benchmark quoted prices. The Corporation uses an independent service provider to provide matrix pricing, and uses the valuation of another provider to compare for reasonableness.

### **Loans Held for Sale (Carried at Lower of Cost or Fair Value)**

The fair values of mortgage loans held for sale are determined based on amounts to be received at settlement by establishing the respective buyer requirement or market interest rates.

### **Loans (Carried at Cost)**

The fair values of non-impaired loans are estimated using discounted cash flow analyses, as well as using market rates at the balance sheet date that reflect the credit and interest rate risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments, and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

### **Impaired Loans (Generally Carried at Fair Value)**

Loans for which the Corporation has measured impairment are 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, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances less the valuation allowance and/or charge-offs.

### **Foreclosed Assets Held for Resale**

The fair value of real estate acquired through foreclosure is based on independent third-party appraisals of the properties. These assets are included as Level 3 fair values, based upon appraisals that consider the sales prices of similar properties in the proximate vicinity.

It is the policy of the Corporation to have the initial market value of a foreclosed asset held for resale determined by an independent third-party valuation. If the Corporation already has a valid appraisal on file for the property and that appraisal has been completed within the previous 12 months, another appraisal shall not be required when the Corporation acquires ownership of that real estate. Further, the Corporation shall update the market value of each foreclosed asset with an independent third-party valuation at least every 18 months, or more frequently if management believes that there is an indication that the fair value has declined. These valuations may be adjusted downward to account for specialized use of the property, change in the condition of the real estate, change in local market and economic conditions, and other specific factors involving the collateral.

**Restricted Investment in Bank Stock (Carried at Cost)**

The carrying amount of required and restricted investment in correspondent bank stock approximates fair value, and considers the limited marketability of such securities.

**Accrued Interest Receivable and Payable (Carried at Cost)**

The carrying amounts of accrued interest receivable and accrued interest payable approximate their fair value.

**Deposits (Carried at Cost)**

The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (e.g., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

**Short-Term Borrowings (Carried at Cost)**

The carrying amounts of short-term borrowings approximate their fair values.

**Long-Term Borrowings (Carried at Cost)**

The fair values of long-term borrowings are estimated using discounted cash flow analysis, based on quoted prices for new borrowings with similar credit risk characteristics, terms, and remaining maturity. The prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party. The fair value of the trust preferred subordinated debt, included in long-term borrowings, was determined based upon an estimated fair value from an independent brokerage firm.

**Off-Balance Sheet Credit-Related Instruments**

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

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Corporation's financial instruments as of September 30, 2017, and December 31, 2016:

September 30, 2017

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In thousands	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial assets:</b>					
Cash and due from banks	\$ 17,882	\$ 17,882	\$ 8,131	\$ 9,751	\$
Interest-bearing deposits in banks	31,609	31,609	31,609		
Investment securities available for sale	158,392	158,392	1,799	156,593	
Investment securities held to maturity	47,369	47,373		47,373	
Loans held for sale	1,873	1,873		1,873	
Loans, less allowance for loan losses	1,222,265	1,205,807			1,205,807
Accrued interest receivable	3,795	3,795		3,795	
Restricted investment in bank stocks	4,821	4,821		4,821	
<b>Financial liabilities:</b>					
Deposits	1,311,884	1,307,677		1,307,677	
Short-term borrowings	33,806	33,806		33,806	
Long-term borrowings	96,850	97,129		97,129	
Accrued interest payable	1,072	1,072		1,072	
<b>Off-balance sheet financial instruments</b>					

In thousands	December 31, 2016				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial assets:</b>					
Cash and due from banks	\$ 13,796	\$ 13,796	\$ 6,921	\$ 6,875	\$
Interest-bearing deposits in banks	5,135	5,135	5,135		
Investment securities available for sale	142,990	142,990	1,716	141,274	
Investment securities held to maturity	55,568	55,425		55,425	
Loans held for sale	1,770	1,770		1,770	
Loans, less allowance for loan losses	893,176	888,169			888,169
Accrued interest receivable	3,158	3,158		3,158	
Restricted investment in bank stocks	4,349	4,349		4,349	
<b>Financial liabilities:</b>					
Deposits	967,621	967,236		967,236	
Short-term borrowings	34,590	34,590		34,590	
Long-term borrowings	74,250	75,029		75,029	
Accrued interest payable	837	837		837	
<b>Off-balance sheet financial instruments</b>					

## 11. Securities Sold Under Agreements to Repurchase (Repurchase Agreements)

The Corporation enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Corporation may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Corporation to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing agreements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Corporation's consolidated statements of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Corporation does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Corporation be in default (e.g., fails to make an interest payment to the counterparty). For private institution repurchase agreements, if the private institution counterparty were to default (e.g., declare bankruptcy), the Corporation could cancel the repurchase agreement (i.e., cease payment of principal and interest), and attempt collection on the amount of collateral value in excess of the repurchase agreement fair value. The collateral is held by a third-party financial institution in the counterparty's custodial account. The counterparty has the right to sell or repledge the investment securities. For government entity repurchase agreements, the collateral is held by the Corporation in a segregated custodial account under a tri-party agreement.



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The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreement as of September 30, 2017, and December 31, 2016:

				Gross Amounts Not Offset in the Statements of Condition			
In thousands		Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statements of Condition	Net Amounts of Liabilities Presented in the Statements of Condition	Financial Instruments	Cash Collateral Pledged	Net Amount
<b>September 30, 2017</b>							
Repurchase agreements							
Commercial customers and government entities	(a) \$	33,806	\$	\$ 33,806	\$ (33,806)	\$	\$
<b>December 31, 2016</b>							
Repurchase agreements							
Commercial customers and government entities	(a) \$	34,590	\$	\$ 34,590	\$ (34,590)	\$	\$

(a) As of September 30, 2017, and December 31, 2016, the fair value of securities pledged in connection with repurchase agreements was \$41,149,000 and \$41,406,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of September 30, 2017:

	Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 Days	30 - 90 Days	Greater than 90 Days	Total
In thousands					
Repurchase agreements and repurchase-to-maturity transactions					
U.S. Treasury and agency securities	\$ 33,806	\$	\$	\$	\$ 33,806
Total	\$ 33,806	\$	\$	\$	\$ 33,806

## 12. Borrowings

The Corporation had long-term debt outstanding as follows:

In thousands	September 30, 2017	December 31, 2016
FHLB Advances	\$ 87,250	\$ 74,250
Loan Payable to local bank	4,600	
Trust preferred subordinated debt	5,000	

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\$	<b>96,850</b>	\$	74,250
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The FHLB advances are collateralized by the assets defined in security agreement and FHLB capital stock. FHLB advances have maturity dates from 2017 to 2021 with a weighted average rate of 1.80%.

The loan payable to a local bank has a one-year draw period in which monthly interest-only payments are due on the outstanding principal amount. Commencing June 2018, terms include a fixed rate of 4.5% for the first five years and a variable rate of interest with Prime Rate thereafter to final maturity in June 2028. The borrower may prepay the principal balance of this note at any time without penalty.

The trust preferred subordinated debt is comprised of debt securities issued by NW Bancorp in June 2005 and assumed by ACNB Corporation through the acquisition. NW Bancorp issued \$5,000,000 of 6.39% fixed rate capital securities to institutional investors in a private pooled transaction. The proceeds were transferred to NW Bancorp as trust preferred subordinated debt under the same terms and conditions. The Corporation then contributed the full amount to the Bank in the form of Tier 1 capital. The Corporation has, through various contractual arrangements, fully and unconditionally guaranteed all of the trust obligations with respect to the capital securities.

### 13. Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights. Intangible assets that have finite lives, such as core deposit intangibles, customer relationship intangibles and renewal lists, are amortized over their estimated useful lives and subject to periodic impairment testing. Core deposit intangibles are primarily amortized over ten years using accelerated methods. Customer renewal lists are amortized over their estimated useful lives which range from eight to thirteen years.

This acquisition of NW Bancorp resulted in goodwill of approximately \$13.3 million and generated \$2.4 million in core deposit intangibles.

Combining goodwill resulting from this transaction with existing goodwill from the 2005 RIG purchase of \$6,308,000, total goodwill included in the Corporation's consolidated statement of condition is \$19,580,000. Goodwill is not deductible for federal income tax purposes. Goodwill, which has an indefinite useful life, is evaluated for impairment annually and is evaluated for impairment more frequently if events and circumstances indicate that the asset might be impaired.

The carrying value and accumulated amortization of the intangible assets (RIG customer lists and NW Bancorp core deposit intangibles) are as follows:

In thousands	Gross carrying amount	Accumulated amortization
RIG amortized intangible assets	\$ 6,667	\$ 6,223
NW Bancorp core deposit intangibles	2,418	110

The RIG intangible assets are being amortized over 10 years on a straight line basis. The NW Bancorp core deposit intangible is being amortized using a sum of the year's method over a 10-year period.

Goodwill is subject to impairment testing at the reporting unit level, which must be conducted at least annually. We perform impairment testing during the fourth quarter of each year, or more frequently if impairment indicators exist. We also continue to monitor other intangibles for impairment and to evaluate carrying amounts, as necessary.

### 14. New Accounting Pronouncements

#### ASU 2014-09, 2015-14, 2016-08, 2016-12, 2016-20, and 2017-10

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*.

The amendments in this Update establish a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation.

The amendments in this Update were originally effective for public entities for annual periods beginning after December 15, 2016, including interim periods therein. Three basic transition methods are available—full retrospective, retrospective with certain practical expedients, and a cumulative effect approach. Under the third alternative, an entity would apply the new revenue standard only to contracts that are incomplete under legacy U.S. GAAP at the date of initial application and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. That is, prior years would not be restated and additional disclosures would be required to enable users of the financial statements to understand the impact of adopting the new standard in the current year compared to prior years that are presented under legacy U.S. GAAP. Early adoption is prohibited under U.S. GAAP.

In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)*.

ASU 2015-14 defers the effective date of the new revenue recognition standard by one year. As such, it now takes effect for public entities in fiscal years beginning after December 15, 2017. All other entities have an additional year. However, early adoption is permitted for any entity that chooses to adopt the new standard as of the original effective date.

Public business entities will adopt the standard for annual reporting periods beginning after December 15, 2017, including interim periods within that year. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year.

In March 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*.

ASU 2016-08 updates the new revenue standard by clarifying the principal versus agent implementation guidance, but does not change the core principle of the new standard. The updates to the principal versus agent guidance:

- require an entity to determine whether it is a principal or an agent for each distinct good or service (or a distinct bundle of goods or services) to be provided to the customer;
- illustrate how an entity that is a principal might apply the control principle to goods, services, or rights to services, when another party is involved in providing goods or services to a customer;
- clarify that the purpose of certain specific control indicators is to support or assist in the assessment of whether an entity controls a good or service before it is transferred to the customer, provide more specific guidance on how the indicators should be considered, and clarify that their relevance will vary depending on the facts and circumstances; and
- revise existing examples and add two new ones to more clearly depict how the guidance should be applied.

In May 2016, the FASB issued ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*.

The amendments do not alter the core principle of the new revenue standard, but make certain targeted changes to clarify the following:

- *Assessing collectibility* - The amendments add a substantially all threshold to the collectibility criterion, and also clarify that the objective of the collectibility assessment is to determine whether the contract is valid and represents a substantive transaction based on whether a customer has the ability and intent to pay for the goods or services that will be transferred to the customer, as opposed to all of the goods or services promised in the contract. The ASU also clarifies how an entity may recognize as revenue consideration received in circumstances where a contract does not meet the criteria required at inception to apply the recognition guidance within the revenue standard.
- *Presenting sales taxes and other similar taxes collected from customers* - The amendments provide an accounting policy election whereby an entity may exclude from the measurement of transaction price all taxes assessed by a taxing authority related to the specific transaction and which are collected from the customer. Such amounts would be presented net under this option.
- *Noncash consideration* - The amendments clarify that the fair value of noncash consideration is measured at contract inception, and specify how to account for subsequent changes in the fair value of noncash consideration.
- *Contract modifications at transition* - The amendments provide a new practical expedient whereby an entity electing either the full or modified retrospective method of transition is permitted to reflect the aggregate effect of all prior period modifications (using hindsight) when identifying satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to satisfied and unsatisfied obligations.

- *Completed contracts at transition* - The amendments include certain practical expedients in transition related to completed contracts. The amendments also clarify the definition of a completed contract.
- *Disclosing the accounting change in the period of adoption* - ASU 2016-12 provides an exception to the requirement in Topic 250 to disclose the effect on the current period of retrospectively adopting a new accounting standard.

In December 2016, the FASB issued ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, which amends the new revenue standard. The amendments do not alter the core principle of the standard, but clarify certain narrow aspects of the standard including contract cost accounting, disclosures, illustrative examples, and other matters.

The effective date and transition requirements for ASU 2016-20 are the same as the effective date and transition requirements of Topic 606.

In May 2017, the FASB issued ASU 2017-10, *Determining the Customer of the Operation Services*, which amends Topic 853 to clarify that when applying Topic 606, an operating entity in a service concession arrangement should consider the grantor to be its customer for the services it provides in all cases. This includes the construction of the infrastructure, if any, as well as operating services.

The FASB ultimately concluded the operating entity is acting as the grantor's service provider to operate and maintain the infrastructure, which is controlled by the grantor, and the only parties to the executed service concession arrangement are the grantor and the operating entity.

The effective date and transition requirements for ASU 2017-10 are the same as the effective date and transition requirements for Topic 606.

The Corporation's revenue is comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09, and non-interest income. With respect to non-interest income, the Corporation has identified revenue streams within the scope of the guidance, and has performed an evaluation of the underlying revenue contracts. Alternative methods are available for cash receipts of contingent commissions from the insurance agency segment. The method chosen will have a bearing on when this revenue source is recognized and can vary from period to period.

#### **ASU 2016-01**

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*.

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ASU 2016-01 amends the guidance on the classification and measurement of financial instruments. Some of the amendments in ASU 2016-01 include the following among others: (i) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (iii) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and, (iv) requires an entity to present separately in other comprehensive income the portion of the total change in the 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.

For public business entities, the amendments of ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

The Corporation is currently evaluating the impact this ASU will have on its consolidated financial condition or results of operations.



## ASU 2016-02

In February 2016, the FASB issued ASU 2016-02, *Leases*.

From the lessee's perspective, the new standard establishes a right-of-use (ROU) model that requires a lessee to record an 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 lessee. 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 lease. If the lessor doesn't convey risks and rewards or control, an operating lease results.

The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

While the Corporation is currently evaluating the timing and impact of adopting ASU 2016-02, the ultimate impact of adopting ASU 2016-02 will depend on the Corporation's lease portfolio as of the adoption date.

## ASU 2016-09

In March 2016, the FASB issued ASU 2016-09, *Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*.

ASU 2016-09 introduces targeted amendments intended to simplify the accounting for stock compensation. Specifically, the ASU requires all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) to be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits, and assess the need for a valuation allowance, regardless of whether the benefit reduces taxes payable in the current period. That is, off balance sheet accounting for net operating losses stemming from excess tax benefits would no longer be required and instead such net operating losses would be recognized when they arise. Existing net operating losses that are currently tracked off balance sheet would be recognized, net of a valuation allowance if required, through an adjustment to opening retained earnings in the period of adoption. Entities will no longer need to maintain and track an APIC pool. The ASU also requires excess tax benefits to be classified along with other income tax cash flows as an operating activity in the statement of cash flows.

In addition, the ASU elevates the statutory tax withholding threshold to qualify for equity classification up to the maximum statutory tax rates in the applicable jurisdiction(s). The ASU also clarifies that cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity.

The ASU provides an optional accounting policy election (with limited exceptions), to be applied on an entity-wide basis, to either estimate the number of awards that are expected to vest (consistent with existing U.S. GAAP) or account for forfeitures when they occur.

The amendments are effective for public business entities for annual periods beginning after December 15, 2016, and interim periods within those annual periods.

The Corporation has evaluated the provision of ASU 2016-09 to determine the potential impact of the new standard and has determined that it does not have an impact on its consolidated financial condition or results of operations.

#### **ASU 2016-13**

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

ASU 2016-13 requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument.

The ASU also replaces the current accounting model for purchased credit impaired loans and debt securities. The allowance for credit losses for purchased financial assets with a more-than insignificant amount of credit deterioration since origination ( PCD assets ), should be determined in a similar manner to other financial assets measured on an amortized cost basis. However, upon initial recognition, the allowance for credit losses is added to the purchase price ( gross up approach ) to determine the initial amortized cost basis. The subsequent accounting for PCD financial assets is the same expected loss model described above.

Further, the ASU made certain targeted amendments to the existing impairment model for available-for-sale (AFS) debt securities. For an AFS debt security for which there is neither the intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a write-down of the amortized cost basis.

Certain incremental disclosures are required. The new standard is effective for fiscal years beginning after December 15, 2019, including interim periods within the fiscal year. For public business entities that are SEC filers, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, with early adoption permitted.

The Corporation is currently evaluating the impact this ASU will have on its consolidated financial condition or results of operations.

#### **ASU 2017-08**

In March 2017, the FASB issued ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities*.

ASU 2017-08 shortens the amortization period for premiums on purchased callable debt securities to the earliest call date (i.e., yield-to-earliest call amortization), rather than amortizing over the full contractual term. The ASU does not change the accounting for securities held at a discount.

The amendments apply to callable debt securities with explicit, noncontingent call features that are callable at fixed prices and on preset dates. If a security may be prepaid based upon prepayments of the underlying loans, not because the issuer exercised a date specific call option, it is excluded from the scope of the new standard. However, for instruments with contingent call features, once the contingency is resolved and the security is callable at a fixed price and preset date, the security is within the scope of the amendments. Further, the amendments apply to all premiums on callable debt securities, regardless of how they were generated.

The amendments require companies to reset the effective yield using the payment terms of the debt security if the call option is not exercised on the earliest call date. If the security has additional future call dates, any excess of the amortized cost basis over the amount repayable by the

issuer at the next call date should be amortized to the next call date.

The amendments are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those years. 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.

The Corporation has evaluated the provision of ASU 2017-08 to determine the potential impact of the new standard and has determined that it is not expected to have a significant impact on its consolidated financial condition or results of operations, as the Corporation holds one security that this ASU would impact.

#### **ASU 2017-07**

In March 2017, the FASB issued ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*.

ASU 2017-07 requires that an employer disaggregate the service cost component from the other components of net benefit cost, as follows:

- Service cost must be presented in the same line item(s) as other employee compensation costs. These costs are generally included within income from continuing operations, but in some cases may be eligible for capitalization, if certain criteria are met.
- All other components of net benefit cost must be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. These generally include interest cost, actual return on plan assets, amortization of prior service cost included in accumulated other comprehensive income, and gains or losses from changes in the value of the projected benefit obligation or plan assets. If a separate line item is used to present the other components of net benefit cost, it must be appropriately described. If a separate line item is not used, an entity must disclose the line item(s) in the income statement that includes the other components of net benefit cost. The ASU clarifies that these costs are not eligible for capitalization.

The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those years. Early adoption is permitted as of the beginning of an annual period.

The Corporation is currently evaluating if this ASU will have an impact on its consolidated financial condition or results of operations.

#### **ASU 2017-04**

In January 2017, the FASB issued ASU 2017-04, *Simplifying the Test for Goodwill Impairment*.

ASU 2017-04 eliminates Step 2 of the goodwill impairment test. As such, an entity will 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 a goodwill impairment charge for the amount by which the reporting unit's carrying amount exceeds its fair value. If fair value exceeds the carrying amount, no impairment should be recorded. Any loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Impairment losses on goodwill cannot be reversed once recognized.

An entity may still perform the optional qualitative assessment for a reporting unit to determine if it is more likely than not that goodwill is impaired. However, the ASU eliminates the requirement to perform a qualitative assessment for any reporting unit with a zero or negative carrying amount. Therefore, the same one-step impairment assessment will apply to all reporting units. However, for a reporting unit with a zero or negative carrying amount, the ASU adds a requirement to disclose the amount of goodwill allocated to it and the reportable segment in which it is included.

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For public business entities that are SEC filers, the amendments are effective with their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

The Corporation has evaluated the provision of ASU 2017-04 to determine the potential impact of the new standard and has determined that it is not expected to have an impact on its consolidated financial condition or results of operations based on the current circumstances.

### ASU 2017-13

In September 2017, the FASB issued ASU 2017-13, *Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842)*.

ASU 2017-13 adds SEC paragraphs pursuant to an SEC Staff Announcement made at the July 20, 2017 Emerging Issues Task Force (EITF) meeting. The SEC staff announced that it will not object if an entity that qualifies as a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC adopts ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)* and ASU 2016-02, *Leases (Topic 842)* using the effective dates applicable to private entities.

The amendments represent guidance related to the effective dates of the standards noted above, therefore, the amendments themselves do not have an effective date.

**ACNB CORPORATION**

**ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**INTRODUCTION AND FORWARD-LOOKING STATEMENTS**

**Introduction**

The following is management's discussion and analysis of the significant changes in the financial condition, results of operations, comprehensive income, capital resources, and liquidity presented in its accompanying consolidated financial statements for ACNB Corporation (the Corporation or ACNB), a financial holding company. Please read this discussion in conjunction with the consolidated financial statements and disclosures included herein. Current performance does not guarantee, assure or indicate similar performance in the future.

**Forward-Looking Statements**

In addition to historical information, this Form 10-Q contains forward-looking statements. Examples of forward-looking statements include, but are not limited to, (a) projections or statements regarding future earnings, expenses, net interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure, and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, and (c) statements of assumptions, such as economic conditions in the Corporation's market areas. Such forward-looking statements can be identified by the use of forward-looking terminology such as *believes*, *expects*, *may*, *intends*, *will*, *should*, *anticipates*, *negative* of any of the foregoing or other variations thereon or comparable terminology, or by discussion of strategy. Forward-looking statements are subject to certain risks and uncertainties such as local economic conditions, competitive factors, and regulatory limitations. Actual results may differ materially from those projected in the forward-looking statements. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: the effects of economic deterioration and the prolonged economic malaise on current customers, specifically the effect of the economy on loan customers' ability to repay loans; the effects of governmental and fiscal policies, as well as legislative and regulatory changes; the effects of new laws and regulations, specifically the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act; impacts of the new capital and liquidity requirements of the Basel III standards; the effects of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters; ineffectiveness of the business strategy due to changes in current or future market conditions; future actions or inactions of the United States government, including the effects of short- and long-term federal budget and tax negotiations and a failure to increase the government debt limit or a prolonged shutdown of the federal government; the effects of competition, and of changes in laws and regulations on competition, including industry consolidation and development of competing financial products and services; the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities, and interest rate protection agreements, as well as interest rate risks; difficulties in acquisitions and integrating and operating acquired business operations, including information technology difficulties; challenges in establishing and maintaining operations in new markets; the effects of technology changes; volatilities in the securities markets; slow economic conditions; the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities; acts of war or terrorism; disruption of credit and equity markets; the ability to manage current levels of impaired assets; the loss of certain key officers; the ability to maintain the value and image of ACNB's brand and protect ACNB's intellectual property rights; continued relationships with major customers; and, potential impacts to ACNB from continually evolving cybersecurity and other technological risks and attacks, including additional costs, reputational damage, regulatory penalties, and financial losses. We caution readers not to place undue reliance on these forward-looking statements. They only reflect management's analysis as of this date. The Corporation does not revise or update these forward-looking statements to reflect events or changed circumstances. Please carefully review the risk factors described in other documents the Corporation files from time to time with the Securities and Exchange Commission, including the Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and any Current Reports on Form 8-K.



## **CRITICAL ACCOUNTING POLICIES**

The accounting policies that the Corporation's management deems to be most important to the portrayal of its financial condition and results of operations, and that require management's most difficult, subjective or complex judgment, often result in the need to make estimates about the effect of such matters which are inherently uncertain. The following policies are deemed to be critical accounting policies by management:

The allowance for loan losses represents management's estimate of probable losses inherent in the loan portfolio. Management makes numerous assumptions, estimates and adjustments in determining an adequate allowance. The Corporation assesses the level of potential loss associated with its loan portfolio and provides for that exposure through an allowance for loan losses. The allowance is established through a provision for loan losses charged to earnings. The allowance is an estimate of the losses inherent in the loan portfolio as of the end of each reporting period. The Corporation assesses the adequacy of its allowance on a quarterly basis. The specific methodologies applied on a consistent basis are discussed in greater detail under the caption, *Allowance for Loan Losses*, in a subsequent section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

The evaluation of securities for other-than-temporary impairment requires a significant amount of judgment. In estimating other-than-temporary impairment losses, management considers various factors including the length of time the fair value has been below cost, the financial condition of the issuer, and the Corporation's intent to sell, or requirement to sell, the security before recovery of its value. Declines in fair value that are determined to be other than temporary are charged against earnings.

Accounting Standard Codification (ASC) Topic 350, *Intangibles – Goodwill and Other*, requires that goodwill is not amortized to expense, but rather that it be assessed or tested for impairment at least annually. Impairment write-downs are charged to results of operations in the period in which the impairment is determined. The Corporation did not identify any impairment on its outstanding goodwill from its most recent testing, which was performed as of October 1, 2016. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested for impairment when such events occur. The Corporation has not identified any such events and, accordingly, has not tested goodwill for impairment during the nine months ended September 30, 2017. Other acquired intangible assets with finite lives, such as customer lists, are required to be amortized over the estimated lives. These intangibles are generally amortized using the straight line method over estimated useful lives of ten years.

## RESULTS OF OPERATIONS

### Quarter ended September 30, 2017, compared to Quarter ended September 30, 2016

#### *Executive Summary*

Net income for the three months ended September 30, 2017, was \$1,912,000, compared to \$2,768,000 for the same quarter in 2016, a decrease of \$856,000 or 30.9%. Earnings per share was \$0.27 in 2017 and \$0.46 in 2016, respectively. The lower net income was a result of merger and integration costs related to the acquisition of New Windsor Bancorp, Inc. ( *NW* ) on July 1, 2017. These direct costs totaled \$4,305,000 in the three months ended September 30, 2017 compared to \$0 of direct costs in the three months ended September 30, 2016. Net interest income for the three month period ended September 30, 2017 increased \$4,377,000, or 47.7%, as increases in total interest income were greater than increases in total interest expense. Provision for loan losses was \$0 for the three month period ended September 30, 2017, no change from the same quarter in 2016, based on the adequacy analysis of the allowance for loan losses calculation at the end of each period, resulting in an allowance to total loans of 1.14% at September 30, 2017. Other income increased \$629,000, or 19.1%, due in part to increases from the *NW* sources, discussed in more detail below. Other expenses not including merger and integration costs increased \$1,782,000, or 20.3%, due in part to higher salary/benefits from a change to higher skilled and compensated staff and expenses related to the operation of the new southern market, *NWSB Bank*, a division of *ACNB Bank* ( *NWSB Bank* ).

#### *Merger with New Windsor Bancorp, Inc.*

On July 1, 2017, the Corporation completed the merger with NW, the parent company of New Windsor State Bank (NWSB), with an aggregate value of approximately \$33.3 million based on the Corporation's June 30, 2017 closing share price. The transaction is expected to qualify as a tax-free reorganization for federal income tax purposes.

The fair value of total assets acquired as a result of the merger totaled \$319.8 million, loans totaled \$263.5 million, and deposits totaled \$293.3 million. The Corporation's presence expanded in north central Maryland complementing and expanding the Corporation's existing network of retail banking offices in southcentral Pennsylvania. Note 2 to the Consolidated Financial Statement, Acquisition of New Windsor Bancorp, Inc., provides detailed financial information related to the transaction.

*Net Interest Income*

Net interest income totaled \$13,562,000 for the quarter ended September 30, 2017, compared to \$9,185,000 for the same period in 2016, an increase of \$4,377,000, or 47.7%. Net interest income increased due to an increase in interest income to a greater extent than an increase in interest expense. Interest income increased \$4,928,000, or 48.4%, due to a 34.6% increase in average earning asset volume from organic growth and the addition of NW assets despite lower rates on new investments that replaced maturing investments. The increase in interest expense resulted from deposit rate increases in addition to organic growth and the addition of NW deposits. Besides the loans acquired from NW, increased lending was a result of a concerted effort by management to offset the recent year trend of interest income decreases due to slow economic activity and declines in the U.S. Treasury yields and other market driver interest rates. These driver rates affect new loan originations and are indexed to a portion of the loan portfolio in that a decrease in the driver rates decreases the yield on new loans and on existing loans at subsequent interest rate reset dates. In this manner, interest income yield is negatively affected as new loans replace paydowns on existing loans and variable rate loans reset to new lower rates. Interest income was higher on investment securities due to investments acquired from NW, otherwise as paydowns were reinvested at the continued low market rates, which were a result of uneven domestic and international economic conditions. An appropriate amount of earning assets remained in short-term, low-rate money market type accounts during the third quarter of 2017; even with increased loan demand, there exists ample ability to borrow for liquidity needs. The ability to increase lending is contingent on the effects of intense competition that can reduce new loans and may result in the payoff of existing loans, as well as economic conditions in the Corporation's marketplace. As to funding costs, interest rates on alternative funding sources, such as the FHLB, and other market driver rates are factors in rates the Corporation and the local market pay for deposits. However, during the third quarter of 2017, several of the core deposit rates continued at low rates in response to continued low rates on earning assets. Interest expense increased \$551,000, or 55.3%, due to higher rates on transaction account deposits, certificate of deposit rate increases and more use of higher cost borrowings. This trend is expected to continue due to competing non-bank money market funding products that gained an advantage when the Federal Reserve FOMC raised short-term rates starting in mid-December 2015 and continued in the fourth quarter of 2016 and first half of 2017. For more information about interest rate risk, please refer to Item 7A Quantitative and Qualitative Disclosures about Market Risk in the Annual Report on Form 10-K for the fiscal year ended December 31, 2016, and filed with the SEC on March 15, 2017. Over the longer term, the Corporation continues its strategic direction to increase asset yield and interest income by means of loan growth and rebalancing the composition of earning assets.

The net interest spread for the third quarter of 2017 was 3.54% compared to 3.21% during the same period in 2016. Also comparing the third quarter of 2017 to 2016, the yield on interest earning assets increased by 0.37% and the cost of interest bearing liabilities increased by 0.04%. The net interest margin was 3.66% for the third quarter of 2017 and 3.30% for the third quarter of 2016. The increase in net interest income and increase in net interest margin during the third quarter of 2017 were both primarily due to the impact of the NW acquisition, which included a full quarter of average net interest-earning assets acquired and related net interest income. The net interest margin increase as a result of purchase accounting adjustments in connection with the NW acquisition added 17 basis points and originating loans at the current market rate in order to increase loan volume and attempt to maintain total net interest income while purchasing less lower yielding investments.

Average earning assets were \$1,488,000,000 during the third quarter of 2017, an increase of \$383,000,000 from the average for the third quarter of 2016. Average interest bearing liabilities were \$1,153,000,000 in the third quarter of 2017, an increase of \$276,000,000 from the same quarter in 2016. Non-interest demand deposits increased \$97,000,000 on average. All increases included the acquisition of NW on July 1, 2017.

*Provision for Loan Losses*

The provision for loan losses was \$0 in the third quarters of 2017 and 2016, respectively. The determination of no need for additional provision was a result of the analysis of the adequacy of the allowance for loan losses calculation. The allowance for loan and lease losses does not include the loans acquired from the NW acquisition which were recorded at fair value as of the acquisition date. Without the NW loans, total impaired loans at September 30, 2017 were 10.9% less than compared to December 31, 2016, however \$3.1 million in two unrelated accruing troubled debt restructurings were moved to nonaccruing when the borrowers indicated that continued payments were not likely. A specific loss allocation was made on the smaller of the two loans, while the larger was considered well collateralized, as outlined in the narrative on the information on

nonaccrual loans table. Nonaccrual loans increased by 48.7%, or \$2,193,000, since December 31, 2016, and all substandard loans increased by 26.1% in that period. Each quarter, the Corporation assesses risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors. Management concluded that the loan portfolio exhibited continued general improvement in quantitative and qualitative measurements as shown in the tables and narrative in this Management's Discussion and Analysis and the Notes to the Consolidated Financial Statements. This assessment concluded that credit quality was stable, charge offs were low, and past due loans were manageable. This same analysis concluded that the unallocated allowance should be in the same range in 2017 compared with the previous quarter. For more information, please refer to *Allowance for Loan Losses* in the following Financial Condition section of this Management's Discussion and Analysis of Financial Condition and Results of Operations. ACNB charges confirmed loan losses to the allowance and credits the allowance for recoveries of previous loan charge-offs. For the third quarter of 2017, the Corporation had net charge-offs of \$43,000, as compared to net charge-offs of \$148,000 for the third quarter of 2016.

*Other Income*

Total other income was \$3,930,000 for the three months ended September 30, 2017, up \$629,000, or 19.1%, from the third quarter of 2016. Fees from deposit accounts increased by \$239,000, or 37.9%, due to increased volume from organic growth and the NW acquisition. Fee volume varies with balance levels, account transaction activity, and customer-driven events such as overdrawing account balances. Various specific government regulations effectively limit fee assessments related to deposit accounts, making future revenue levels uncertain. Revenue from ATM and debit card transactions increased by \$109,000 or 28.6%, to \$490,000 due to variations in volume and mix, including volume from NW customers. The longer term trend had been increases resulting from consumer desire to use more electronic delivery channels; however, regulations or legal challenges for large financial institutions may impact industry pricing for such transactions and fees in connection therewith in future periods, the effect of which cannot be currently quantified. A more immediate challenge to this revenue source is the retail system wide security breaches in the merchant base that are negatively affecting consumer confidence in the debit card channel. Income from fiduciary activities, which includes fees from both institutional and personal trust and investment management services and estate settlement services, totaled \$489,000 for the three months ended September 30, 2017, as compared to \$416,000 for the third quarter of 2016, a 17.5% net increase as a result of higher fee volume from increased assets under management net of lower estate fee income, which is inherently sporadic in nature. Earnings on bank-owned life insurance decreased by \$0, or 0.0%, as a net result of increased volume, varying crediting rates on increased accreted values. At the Corporation's wholly-owned insurance subsidiary, Russell Insurance Group, Inc. (RIG), revenue was up by \$44,000, or 3.5%, to \$1,313,000 due to higher direct bill commissions and contingent commissions. A continuing risk to RIG revenue is nonrenewal of large commercial accounts and actions by insurance carriers to reduce commissions paid to agencies such as RIG. Contingent or extra commission payments from insurance carriers are received in the second quarter of each year. Heightened pressure on commissions is expected to continue in this business line from insurance company actions; and contingent commissions are not totally predictable. There were no gains or losses on sales of securities during the third quarters of 2017 and 2016. Other income in the quarter ended September 30, 2017, was up by \$164,000, or 50.0%, to \$492,000 due to increased sales of residential mortgages and related fee income from the NW acquisition.

*Other Expenses*

Other expenses for the quarter ended September 30, 2017 were \$14,867,000, an increase of \$6,087,000 or 69.3%. Acquisition and integration costs related to the NW acquisition totaled \$4,305,000 for the third quarter of 2017 compared to \$0 for the third quarter of 2016. Merger expenses included legal and consulting expenses to effect the legal merger, investment banking and preparing purchase accounting adjustments. Integration expenses included severance payments to NW staff separated by the merger, consultant costs to integrate NW bank systems into ACNB's, and the cost to terminate all NW core banking and electronic technology systems contracts. These costs were all necessary to provide requisite internal controls and cost effective core banking technology systems going forward. The costs of integrating all systems into one system was important to the merger viability and the ongoing system integrity and quality.

Other than acquisition and integration costs, the largest component of other expenses is salaries and employee benefits, which increased by \$1,135,000, or 20.3%, when comparing the third quarter of 2017 to the same quarter a year ago. Overall, the increase in salaries and employee benefits was the result of:

- retaining customer-facing staff in the NWSB Bank markets to retain key loan and deposit relationships;
- increased staff in support functions and higher skilled mix of employees necessitated by regulations and growth;

- normal merit increases to employees and associated payroll taxes;
- higher performance-based commissions and incentives;
- higher employee benefit plan costs, including health insurance;
- increases related to 401(k) plan and non-qualified retirement plan benefits; and,

- defined benefit pension expense, which was down by \$13,000, or 28.3%, when comparing the three months ended September 30, 2017, to the three months ended September 30, 2016, resulting from the change in discount rates which increases or decreases the future pension obligations (creating volatility in the expense), return on assets at the latest annual evaluation date due to market conditions and changes in actuarial assumptions reflecting increased longevity.

The Corporation's overall pension plan investment strategy is to achieve a mix of investments to meet the long-term rate of return assumption and near-term pension obligations with a diversification of asset types, fund strategies, and fund managers. The mix of investments is adjusted periodically by retaining an advisory firm to recommend appropriate allocations after reviewing the Corporation's risk tolerance on contribution levels, funded status, plan expense, as well as any applicable regulatory requirements. However, the determination of future benefit expense is also dependent on the fair value of assets and the discount rate on the year-end measurement date, which in recent years has experienced fair value volatility and low discount rates. The expense could also be higher in future years due to volatility in the discount rates at the latest measurement date, lower plan returns, and change in mortality tables utilized. The ACNB plan has maintained a well-funded status under ERISA rules.

Net occupancy expense increased by \$196,000, or 40.7%, mostly due to more offices from the NW acquisition. Equipment expense increased by \$299,000, or 40.4%, as a result of more technology equipment and software maintenance expenses. In addition, debit card processing increased due to more volume.

Professional services expense totaled \$224,000 for the third quarter of 2017, as compared to \$217,000 for the same period in 2016, an increase of \$7,000, or 3.2%. This category includes expenses related to legal corporate governance, risk and compliance management engagements, and legal counsel matters in connection with loans. It varies with specific engagements that are not on a regular recurring basis.

Marketing and corporate relations expenses were \$119,000 for the quarter, or 3.3% lower in the third quarter of 2017, as compared to the same period of 2016. Marketing expense varies with the timing and amount of planned advertising production and media expenditures, typically related to the promotion of certain in-market banking and trust products.

Foreclosed assets held for resale consist of the fair value of real estate acquired through foreclosure on real estate loan collateral or the acceptance of ownership of real estate in lieu of the foreclosure process. Fair values are based on appraisals that consider the sales prices of similar properties in the proximate vicinity less estimated selling costs. Foreclosed real estate expense was \$35,000 and \$72,000 for the quarters ended September 30, 2017 and 2016, respectively. The expense varies based upon the number and mix of commercial and residential real estate properties, unpaid property taxes, and deferred maintenance required upon acquisition. In addition, some properties suffer decreases in value after acquisition, requiring write-downs to fair value during the prolonged marketing cycles for these distressed properties. The decreased expense in the third quarter of 2017 is related to less properties held. Foreclosed assets held for resale expenses or recoveries will vary in the remainder of 2017 depending on the successful closing of sales agreements on some existing properties and the unknown expenses related to new properties acquired.

Other tax expense decreased by \$4,000, or 2.0%, comparing the quarters ended September 30, 2017 and 2016, due to a recovery on sales tax challenge received offsetting higher Pennsylvania Bank Shares Tax. The Pennsylvania Bank Shares Tax is a shareholders' equity-based tax and is subject to increases based on state government budget proposals. Pennsylvania raised the Bank Shares Tax from 0.89% to 0.95% effective January 1, 2017. Supplies and postage expense increased by 5.1% in part due to variation in timing of sporadic refills. FDIC and regulatory expense decreased 6.1% based on FDIC decreases partially offset scheduled state regulatory rate increases. Intangible amortization increased 127.1% due to amortization of core deposit intangible from the NW acquisition. Other operating expenses increased by \$84,000, or 9.1%, in the



third quarter of 2017, as compared to the third quarter of 2016. Increases and decreases included normal variations for electronic delivery channels, telecommunications, and director fees, as well as various other categories. Losses, which include the expense of reimbursing debit card customers for unauthorized transactions to their accounts resulting from various merchant database breaches and other third-party fraudulent use, added approximately \$11,000 to other expenses in the third quarter of 2017 compared to \$19,000 in 2016. These third-party breaches also cause additional card inventory and processing costs to the Corporation, none of which is expected to be recovered from the third-party merchants or other parties where the breaches occur. The debit card electronic delivery channel is valued by customers and provides significant revenue to the Corporation. The expense related to reimbursements is unpredictable and varying, but ACNB has policies and procedures to limit exposure.

*Provision for Income Taxes*

The Corporation recognized income taxes of \$713,000, or 27.2% of pretax income, during the third quarter of 2017, as compared to \$938,000, or 25.3% of pretax income, during the same period in 2016. The variances from the federal statutory rate of 35% in both periods are generally due to tax-exempt income from investments in and loans to state and local units of government at below-market rates (an indirect form of taxation), investment in bank-owned life insurance, and investments in low-income housing partnerships (which qualify for federal tax credits). Low-income housing tax credits were \$72,000 for the third quarters of 2017 and 2016, respectively.

**Nine Months ended September 30, 2017, compared to Nine Months ended September 30, 2016**

*Executive Summary*

Net income for the nine months ended September 30, 2017, was \$7,271,000, compared to \$8,297,000 for the same nine months in 2016, a decrease of \$1,026,000 or 12.4%. Earnings per share was \$1.14 in 2017 and \$1.37 in 2016 respectively. The lower net income was a result of merger and integration costs related to the acquisition of NW on July 1, 2017. These direct costs totaled \$4,675,000 in the nine months ended September 30, 2017 compared to \$0 of direct costs in the nine months ended September 30, 2016. Net interest income for the nine month period ended September 30, 2017 increased \$5,637,000, or 20.7%, as increases in total interest income were greater than increases in total interest expense. Provision for loan losses was \$0 for the nine month period ended September 30, 2017, no change from the same quarter in 2016, based on the adequacy analysis of the allowance for loan losses calculation at the end of each period, resulting in an allowance to total loans of 1.14% at September 30, 2017. Other income increased \$556,000, or 5.6%, due in part to increases from the NW sources. Other expenses not including merger and integration costs increased \$2,725,000, or 10.4%, due in part to higher salary/benefits from a change to higher skilled and compensated staff and expenses related to the operation of the new southern market, NWSB Bank, a division of ACNB Bank.

*Net Interest Income*

Net interest income totaled \$32,859,000 for the nine months ended September 30, 2017, compared to \$27,222,000 for the same period in 2016, an increase of \$5,637,000, or 20.7%. Net interest income increased due to an increase in interest income to a greater extent than an increase in interest expense. Interest income increased \$6,449,000, or 21.4%, due to a 17.1% increase in average earning asset volume from organic growth and the July 1, 2017 addition of NW assets despite lower rates on new investments that replaced maturing investments. The increase in interest expense resulted from deposit rate increases in addition to organic growth and the addition of NW deposits. Increased lending was a result of a concerted effort by management to offset the recent year trend of interest income decreases due to slow economic activity and declines in the U.S. Treasury yields and other market driver interest rates. These driver rates affect new loan originations and are indexed to a portion of the loan portfolio in that a decrease in the driver rates decreases the yield on new loans and on existing loans at subsequent interest rate reset dates. In this manner, interest income yield is negatively affected as new loans replace paydowns on existing loans and variable rate loans reset to new lower rates. Interest income was lower on investment securities due to investments acquired from NW, otherwise as paydowns were reinvested at the continued low market rates, which were a result of uneven domestic and international economic conditions. An appropriate amount of earning assets remained in short-term, low-rate money market type accounts during the first nine months of 2017; even with increased loan demand, there exists ample ability to borrow for liquidity needs. The ability to increase lending is contingent on the effects of intense competition that can reduce new loans and may result in the payoff of existing loans, as well as economic conditions in the Corporation's marketplace. As to funding costs, interest rates on alternative funding sources, such as the FHLB, and other market driver rates are factors in rates the Corporation and the local market pay for deposits. However, during the first nine months of 2017, several of the core deposit rates continued at low rates in response to continued low rates on earning assets. Interest expense increased \$812,000, or 27.7%, due to higher rates due to higher rates on transaction deposits, certificate of deposit rate increase and more use of higher cost borrowings. This trend is expected to continue due to competing non-bank money market funding products that gained an advantage when the Federal Reserve FOMC raised short-term rates starting in mid-December 2015 and continued in the fourth quarter of 2016 and first quarter of 2017. For more information about interest rate risk, please refer to Item 7A Quantitative and Qualitative Disclosures about Market Risk in the Annual Report on Form 10-K for the fiscal year ended December 31, 2016, and filed with the SEC on March 15, 2017. Over the longer term, the Corporation continues its strategic direction to increase asset yield and interest income by means of loan growth and rebalancing the composition of earning assets.

The net interest spread for the first nine months of 2017 was 3.37% compared to 3.27% during the same period in 2016. Also comparing the first nine months of 2017 to 2016, the yield on interest earning assets increased by 0.15% and the cost of interest bearing liabilities increased by 0.05%. The net interest margin was 3.48% for the first nine months of 2017 and 3.36% for the first nine months of 2016. The net interest margin increase was mainly a result of purchased accounting adjustments which added 7 basis points and acquiring and originating loans at the current market rate in order to increase loan volume and attempt to maintain total net interest income net of purchasing lower yielding investments after

to properly collateralize local government accounts and repurchase agreements.

Average earning assets were \$1,262,000,000 during the first nine months of 2017, an increase of \$185,000,000 from the average for the first nine months of 2016. Average interest bearing liabilities were \$1,002,000,000 in the first nine months of 2017, an increase of \$136,000,000 from the same period in 2016. Non-interest demand deposits increased \$46,000,000 on average.

#### *Provision for Loan Losses*

The provision for loan losses was \$0 in the first nine months of 2017 and 2016. The determination of no need for additional provision was a result of the analysis of the adequacy of the allowance for loan losses calculation. The allowance for loan and lease losses does not include the loans acquired from the NW acquisition which were recorded at fair value as of the acquisition date. Without the NW loans, total impaired loans at September 30, 2017 were 10.9% lower compared to December 31, 2016, however \$3.1 million in two unrelated accruing troubled debt restructurings were moved to nonaccruing when the borrowers indicated that continued payments were not likely. A \$117,000 specific loss allocation was made on the smaller of the two loans, while the larger was considered well collateralized, as outlined in the narrative on the information on nonaccrual loans table. Because of this movement from accruing troubled debt restructurings to nonaccruing troubled debt restructurings, nonaccrual loans increased by 48.7%, or \$2,193,000, since December 31, 2016; all substandard loans increased by 26.1% in that period. Each quarter, the Corporation assesses risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors. Management concluded that the loan portfolio exhibited continued general improvement in quantitative and qualitative measurements as shown in the tables and narrative in this Management's Discussion and Analysis and the Notes to the Consolidated Financial Statements. This assessment concluded that credit quality was stable, charge offs were low, and past due loans manageable. This same analysis concluded that the unallocated allowance should be in the same range in 2017 compared with the previous quarter. For more information, please refer to *Allowance for Loan Losses* in the following Financial Condition section of this Management's Discussion and Analysis of Financial Condition and Results of Operations. ACNB charges confirmed loan losses to the allowance and credits the allowance for recoveries of previous loan charge-offs. For the first nine months of 2017, the Corporation had net charge-offs of \$89,000, as compared to net charge-offs of \$259,000 for the first nine months of 2016.

#### *Other Income*

Total other income was \$10,540,000 for the nine months ended September 30, 2017, up \$556,000, or 5.6%, from the first nine months of 2016. Fees from deposit accounts increased by \$323,000, or 18.6%, due to variations in volume from organic growth and the NW acquisition. Fee volume varies with balance levels, account transaction activity, and customer-driven events such as overdrawing account balances. Various specific government regulations effectively limit fee assessments related to deposit accounts, making future revenue levels uncertain. Revenue from ATM and debit card transactions increased by \$102,000 or 9.1%, to \$1,229,000 due to variations in volume and mix including volume from NW customers. The longer term trend had been increases resulting from consumer desire to use more electronic delivery channels; however, regulations or legal challenges for large financial institutions may impact industry pricing for such transactions and fees in connection therewith in future periods, the effect of which cannot be currently quantified. A more immediate challenge to this revenue source is the retail system-wide security breaches in the merchant base that are negatively affecting consumer confidence in the debit card channel. Income from fiduciary activities, which includes fees from both institutional and personal trust and investment management services and estate settlement services, totaled \$1,409,000 for the nine months ended September 30, 2017, as compared to \$1,244,000 for the first nine months of 2016, a 13.3% net increase as a result of higher fee volume from increased assets under management net of lower estate fee income, which is inherently sporadic in nature. Earnings on bank-owned life insurance decreased by \$27,000, or 3.2%, as a result of varying crediting rates. At the Corporation's wholly-owned insurance subsidiary, Russell Insurance Group, Inc. (RIG), revenue was up by \$331,000, or 8.9%, to \$4,031,000 due to higher direct bill and contingent commissions. A continuing risk to RIG revenue is nonrenewal of large commercial accounts and actions by insurance carriers to reduce commissions paid to agencies such as RIG. Contingent or extra commission payments from insurance carriers are received in the second quarter of each year. Heightened pressure on commissions is expected to continue in this business line from insurance company actions; and contingent commissions are not totally predictable. There were no gains or losses on sales of securities during the first nine months of 2017 and 2016. There was a \$449,000 gain on the sale of a bank administrative office building in the second quarter of 2016, in order to gain better efficiencies. Other income in the nine months ended September 30, 2017, was up by \$111,000, or 12.4%, to \$1,007,000 due to higher sales of residential mortgages and related fee income from the NW acquisition.



### *Impairment Testing*

RIG has certain long-lived assets, including purchased intangible assets subject to amortization, such as insurance books of business, and associated goodwill assets, which are reviewed for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the statement of condition and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill, which has an indefinite useful life, is evaluated for impairment annually and is evaluated for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. Accounting rules permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The goodwill impairment analysis currently used by the Corporation is a two-step test. The first step, used to identify potential impairment, involves comparing the reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds the estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. If required, the second step involves calculating an implied fair value of goodwill for the reporting unit for which the first step indicated potential impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit to a group of likely buyers whose cash flow estimates could differ from those of the reporting entity, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. Subsequent reversal of goodwill impairment losses is not permitted. The testing for potential impairment involved methods that include both current and projected income amounts, and RIG's fair value remained above the carrying value as of the most recent annual impairment test date. Thus, the results of the annual evaluations determined that there is no impairment of goodwill, including the testing at October 1, 2016. However, future declines in RIG's net income or changes in external market factors, including likely buyers that are assumed in impairment testing, may require an impairment charge to goodwill. Should it be determined in a future period that the goodwill has been impaired, then a charge to earnings will be recorded in the period that such a determination is made. Further, a new FASB update to eliminate the second step test, thus basing impairment on the estimated fair value to the carrying value including goodwill.

### *Other Expenses*

Other expenses for the nine months ended September 30, 2017 were \$33,501,000, an increase of \$7,400,000 or 28.4%. Acquisition and integration costs related to the NW acquisition totaled \$4,675,000 for the third quarter of 2017 compared to \$0 for the third quarter of 2016. Merger expenses included legal and consulting expenses to effect the legal merger, investment banking and preparing purchase accounting adjustments. Integration expenses included certain severance payments to NW staff separated by the merger, consultant costs to integrate NW bank systems into ACNB's, and the cost to terminate all NW core banking and electronic technology systems contracts. These costs were all necessary to provide requisite internal controls and cost effective core banking technology systems going forward. The costs of integrating all systems into one system was important to the merger viability and ongoing system integrity and quality.

The largest component of other expenses is salaries and employee benefits, which increased by \$1,788,000, or 10.8%, when comparing the first nine months of 2017 to the same period a year ago. Overall, the increase in salaries and employee benefits was the result of:

- retaining customer-facing staff in the NWSB Bank markets to retain key loan and deposit relationships;
- increased staff in support functions and higher skilled mix of employees necessitated by regulations and growth;
- normal merit increases to employees and associated payroll taxes;
- higher performance-based commissions and incentives;

- higher employee benefit plan costs, including health insurance;
- increases related to 401(k) plan and non-qualified retirement plan benefits; and,
- defined benefit pension expense, which was down by \$39,000, or 28.3%, when comparing the nine months ended September 30, 2017, to the nine months ended September 30, 2016, resulting from the change in discount rates which increases or decreases the future pension obligations (creating volatility in the expense), return on assets at the latest annual evaluation date due to market conditions and changes in actuarial assumptions reflecting increased longevity.

The Corporation's overall pension plan investment strategy is to achieve a mix of investments to meet the long-term rate of return assumption and near-term pension obligations with a diversification of asset types, fund strategies, and fund managers. The mix of investments is adjusted periodically by retaining an advisory firm to recommend appropriate allocations after reviewing the Corporation's risk tolerance on contribution levels, funded status, plan expense, as well as any applicable regulatory requirements. However, the determination of future benefit expense is also dependent on the fair value of assets and the discount rate on the year-end measurement date, which in recent years has experienced fair value volatility and low discount rates. The expense could also be higher in future years due to volatility in the discount rates at the latest measurement date, lower plan returns, and change in mortality tables utilized. The ACNB plan has maintained a well-funded status under ERISA rules.

Net occupancy expense increased by \$157,000, or 10.1%, mostly due to more offices from the NW acquisition. Equipment expense increased by \$454,000, or 20.5%, as a result of more technology equipment, software maintenance expenses. In additions, debit card processing increased due to more volume.

Professional services expense totaled \$807,000 during the first nine months of 2017, as compared to \$670,000 for the same period in 2016, an increase of \$137,000, or 20.4%. This category includes expenses related to legal corporate governance, risk and compliance management engagements, and legal counsel matters in connection with loans. It varies with specific engagements that are not on a regular recurring basis.

Marketing and corporate relations expenses were \$321,000 for the first nine months of 2017, or 17.9% lower, as compared to the same period of 2016. Marketing expense varies with the timing and amount of planned advertising production and media expenditures, typically related to the promotion of certain in-market banking and trust products. Some of the higher expense in 2016 was also related to the opening of a new retail banking office location and the relocation of another office.

Foreclosed assets held for resale consist of the fair value of real estate acquired through foreclosure on real estate loan collateral or the acceptance of ownership of real estate in lieu of the foreclosure process. Fair values are based on appraisals that consider the sales prices of similar properties in the proximate vicinity less estimated selling costs. Foreclosed real estate expense was \$51,000 and \$112,000 for the nine months ended September 30, 2017 and 2016, respectively. The expense varies based upon the number and mix of commercial and residential real estate properties, unpaid property taxes, and deferred maintenance required upon acquisition. In addition, some properties suffer decreases in value after acquisition, requiring write-downs to fair value during the prolonged marketing cycles for these distressed properties. The decreased expense in 2017 is related to less properties. Foreclosed assets held for resale expenses or recoveries will vary in the remainder of 2017 depending on the successful closing of sales agreements on some existing properties and the unknown expenses related to new properties



acquired.

Other tax expense decreased by \$15,000, or 2.5%, comparing the nine months ended September 30, 2017 and 2016, due to recoveries on a sales tax challenge received offsetting higher Bank Shares Tax. The Pennsylvania Bank Shares Tax is a shareholders' equity-based tax and is subject to increases based on state government budget proposals. Pennsylvania raised the Bank Shares Tax from 0.89% to 0.95% effective January 1, 2017. Supplies and postage expense increased by 6.7% due to variation in timing of sporadic refills. FDIC and regulatory expense decreased 15.6% based on FDIC decreases that partially offset scheduled state regulatory rate increases. Intangible amortization increased 37.1% due to amortization of core deposit intangible from the NW acquisition. Other operating expenses increased by \$289,000, or 10.8%, in the first nine months of 2017, as compared to the first nine months of 2016. Increases included increased for electronic delivery and telecommunications for the expanded NW customer base and offices and increased corporate governance expense. Losses, which include the expense of reimbursing debit card customers for unauthorized transactions to their accounts resulting from various merchant database breaches and other third-party fraudulent use, added approximately \$70,000 to other expenses in the first nine months of 2017 compared to \$41,000 in the first half of 2016. Third-party breaches also cause additional card inventory and processing costs to the Corporation, none of which is expected to be recovered from the third-party merchants or other parties where the breaches occur. The debit card electronic delivery channel is valued by customers and provides significant revenue to the Corporation. The expense related to reimbursements is unpredictable and varying, but ACNB has policies and procedures to limit exposure.

### *Provision for Income Taxes*

The Corporation recognized income taxes of \$2,627,000, or 26.5% of pretax income, during the first nine months of 2017, as compared to \$2,808,000, or 25.3% of pretax income, during the same period in 2016. The variances from the federal statutory rate of 35% in both periods are generally due to tax-exempt income from investments in and loans to state and local units of government at below-market rates (an indirect form of taxation), investment in bank-owned life insurance, and investments in low-income housing partnerships (which qualify for federal tax credits). Low-income housing tax credits were \$215,000 for the nine months ended September 30, 2017 and 2016, respectively.

### **FINANCIAL CONDITION**

Assets totaled \$1,607,635,000 at September 30, 2017, compared to \$1,206,320,000 at December 31, 2016, and \$1,208,869,000 at September 30, 2016. Average earning assets during the nine months ended September 30, 2017, increased to \$1,262,000,000 from \$1,078,000,000 during the same period in 2016. Average interest bearing liabilities increased in 2017 to \$1,002,000,000 from \$866,000,000 in 2016, while average non-interest bearing deposits increased by \$46,000.

### *Investment Securities*

ACNB uses investment securities to generate interest and dividend income, manage interest rate risk, provide collateral for certain funding products, and provide liquidity. The changes in the securities portfolio were from the NW acquisition (available for sale fair value at acquisition of \$21,624,000) net of purchases and matured securities to provide proper collateral for public deposits. Investing into investment security portfolio assets over the last several years was made more challenging due to the Federal Reserve Bank's program commonly called Quantitative Easing in which, by the Federal Reserve's open market purchases, the yields are maintained at a lower level than would otherwise be the case. The investment portfolio is comprised of U.S. Government agency, municipal, and corporate securities. These securities provide the appropriate characteristics with respect to credit quality, yield and maturity relative to the management of the overall balance sheet.

At September 30, 2017, the securities balance included a net unrealized gain on available for sale securities of \$40,000, net of taxes, on amortized cost of \$158,330,000 versus a net unrealized loss of \$266,000, net of taxes, on amortized cost of \$143,393,000 at December 31, 2016, and a net unrealized gain of \$1,679,000, net of taxes, on amortized cost of \$141,396,000 at September 30, 2016. The change in fair value of available for sale securities during 2017 was a result of an increase in fair value from a decrease in the U.S. Treasury yield curve rates, and the spread from this yield curve required by investors on the types of investment securities that ACNB owns. The Federal Reserve ceased their rate-decreasing Quantitative Easing program in 2014 and increased the fed funds rate in mid-December 2015 and 2016 and twice to date in 2017. Other domestic and international events however have caused the U.S. Treasury yield curve to decrease in the time terms relevant to the investment securities in the Corporation's portfolio as of September 30, 2017. Actions or lack of actions by the Federal Reserve and markets concern about domestic and global conditions lead to fair values being volatile on any given day in all periods presented.

At September 30, 2017, the securities balance included held to maturity securities with an amortized cost of \$47,369,000 and a fair value of \$47,373,000, as compared to an amortized cost of \$55,568,000 and a fair value of \$55,425,000 at December 31, 2016, and an amortized cost of \$57,562,000 and a fair value of \$58,566,000 at September 30, 2016. The held to maturity securities are U.S. government agency debentures and pass-through mortgage-backed securities in which the full payment of principal and interest is guaranteed; however, they were not classified as available for sale because these securities are generally used as required collateral for certain eligible government accounts or repurchase agreements. They are also held for possible pledging to access additional liquidity for banking subsidiary needs in the form of FHLB borrowings.

The Corporation does not own investments consisting of pools of Alt-A or subprime mortgages, private label mortgage-backed securities, or trust preferred investments.

The fair values of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1) or by matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific security but rather by relying on the security's relationship to other benchmark quoted prices. The Corporation uses independent service providers to provide matrix pricing. Please refer to Note 7 Securities in the Notes to Consolidated Financial Statements for more information on the security portfolio and Note 9 Fair Value Measurements in the Notes to Consolidated Financial Statements for more information about fair value.

*Loans*

Loans outstanding increased by \$364,347,000, or 41.8%, from September 30, 2016, to September 30, 2017, and increased by \$328,460,000, or 36.2%, from December 31, 2016, to September 30, 2017. The increase in loan volume was from the fair value acquired from NW of \$263,450,000 at July 1, 2017 and \$100,897,000 as the result of determined efforts by management to lend to creditworthy borrowers subject to the Corporation's disciplined underwriting standards, despite the continued slow economic conditions and intense competition. In all periods, residential real estate lending and refinance activity was slow and commercial loans were subject to refinancing to competition for different rates or terms. As normal course of business, more payoffs are anticipated in the remainder of 2017 from either customers' cash reserves or refinancing at competing banks. Nonetheless, during the first nine months of 2017, total commercial purpose loans increased while local market portfolio residential mortgages also increased but to a lesser extent. Total commercial purpose segments increased \$217,894,000, or 45.9%, as compared to December 31, 2016. These loans are spread among diverse categories that include municipal governments/school districts, commercial real estate, commercial real estate construction, and commercial and industrial. Included in the commercial, financial and agricultural category are loans to Pennsylvania school districts, municipalities (including townships) and essential purpose authorities. In most cases, these loans are backed by the general obligation of the local government body. In many cases, these loans are obtained through a bid process with other local and regional banks. The loans are bank qualified for mostly tax free interest income treatment for federal income taxes. These loans totaled \$89,355,000 at September 30, 2017, an increase of 21.9% over \$73,272,000 held at the end of 2016, however these loans are especially subject to refinancing. Residential real estate mortgage lending, which includes smaller commercial purpose loans secured by the owner's home, increased by \$108,234,000, or 25.9%, as compared to December 31, 2016. These loans are to local borrowers who preferred loan types that would not be sold into the secondary mortgage market. Of the \$526,845,000 total in residential mortgage loans at September 30, 2017, \$139,952,000 were secured by junior liens or home equity loans, which are also in many cases junior liens. Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a senior security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market weakens, property values deteriorate, or rates increase sharply. Non-real estate secured consumer loans comprise less than 2.0% of the portfolio, with automobile-secured loans representing 0.05% of the portfolio.

Most of the Corporation's lending activities are with customers located within southcentral Pennsylvania and in the northern Maryland area that is proximal to its Pennsylvania and Maryland retail banking offices. This region currently and historically has lower unemployment than the U.S. as a whole. Included in commercial real estate loans are loans made to lessors of non-residential properties that total \$265,208,000, or 21.5% of total loans, at September 30, 2017. These borrowers are geographically dispersed throughout ACNB's marketplace and are leasing commercial properties to a varied group of tenants including medical offices, retail space, and other commercial purpose facilities. Because of the varied nature of the tenants, in aggregate, management believes that these loans present an acceptable risk when compared to commercial loans in general. ACNB does not originate or hold Alt-A or subprime mortgages in its loan portfolio.

*Allowance for Loan Losses*

ACNB maintains the allowance for loan losses at a level believed to be adequate by management to absorb probable losses in the loan portfolio, and it is funded through a provision for loan losses charged to earnings. On a quarterly basis, ACNB utilizes a defined methodology in determining the adequacy of the allowance for loan losses, which considers specific credit reviews, past loan losses, historical experience, and qualitative factors. This methodology results in an allowance that is considered appropriate in light of the high degree of judgment required and that is prudent and conservative, but not excessive.

Management assigns internal risk ratings for each commercial lending relationship. Utilizing historical loss experience, adjusted for changes in trends, conditions, and other relevant factors, management derives estimated losses for non-rated and non-classified loans. When management identifies impaired loans with uncertain collectibility of principal and interest, it evaluates a specific reserve on a quarterly basis in order to estimate potential losses. Management's analysis considers:

- adverse situations that may affect the borrower's ability to repay;
- the current estimated fair value of underlying collateral; and,
- prevailing market conditions.

If management determines a loan is not impaired, a specific reserve allocation is not required. Management then places the loan in a pool of loans with similar risk factors and assigns the general loss factor to determine the reserve. For homogeneous loan types, such as consumer and residential mortgage loans, management bases specific allocations on the average loss ratio for the previous twelve quarters for each specific loan pool. Additionally, management adjusts projected loss ratios for other factors, including the following:

- lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;
- national, regional and local economic and business conditions, as well as the condition of various market segments, including the impact on the value of underlying collateral for collateral dependent loans;
- nature and volume of the portfolio and terms of loans;
- experience, ability and depth of lending management and staff;
- volume and severity of past due, classified and nonaccrual loans, as well as other loan modifications; and,
- existence and effect of any concentrations of credit and changes in the level of such concentrations.

Management determines the unallocated portion of the allowance for loan losses, which represents the difference between the reported allowance for loan losses and the calculated allowance for loan losses, based on the following criteria:

- the risk of imprecision in the specific and general reserve allocations;
- the perceived level of consumer and small business loans with demonstrated weaknesses for which it is not practicable to develop specific allocations;
- other potential exposure in the loan portfolio;

- variances in management's assessment of national, regional and local economic conditions; and,
- other internal or external factors that management believes appropriate at that time.

The unallocated portion of the allowance is deemed to be appropriate as it reflects an uncertainty that remains in the loan portfolio; specifically reserves where the Corporation believes that tertiary losses are probable above the loss amount derived using appraisal-based loss estimation, where such additional loss estimates are in accordance with regulatory and GAAP guidance. Appraisal-based loss derivation does not fully develop the loss present in certain unique, ultimately bank-owned collateral. The Corporation has determined that the amount of provision in 2017 and the resulting allowance at September 30, 2017, are appropriate given the continuing level of risk in the loan portfolio. Further, management believes the unallocated allowance is appropriate, because even though the impaired loans decreased since 2016 the growth in the loan portfolio is centered around commercial real estate which continues to have little increase in value and low liquidity. In addition, there are certain loans that, although they did not meet the criteria for impairment, management believes there was a strong possibility that these loans represented potential losses at September 30, 2017. The amount of unallocated was decreased at September 30, 2017 as management concluded that the loan portfolio exhibited continued general improvement in quantitative and qualitative measurements. This assessment concluded that credit quality was stable, charge offs were low, and past due loans manageable.

Management believes the above methodology accurately reflects losses inherent in the portfolio. Management charges actual loan losses to the allowance for loan losses. Management periodically updates the methodology and the assumptions discussed above.

Management bases the provision for loan losses, or lack of provision, on the overall analysis taking into account the methodology discussed above, which is consistent with recent improvement in the credit quality in the loan portfolio. The provision for year-to-date September 30, 2017 and 2016, was \$0. More specifically, even though total loans increased, there was no provision expense because of the fact that most impaired credits were, in the opinion of management, adequately collateralized.

Federal and state regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

Based on management's comprehensive analysis of the loan portfolio and economic conditions, management believes the current level of the allowance for loan losses is adequate.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. Upon adoption, the change in this accounting guidance could result in an increase in the Corporation's allowance for loan losses and require the Corporation to record loan losses more rapidly.

The allowance for loan losses at September 30, 2017, was \$14,105,000, or 1.14% of loans, as compared to \$14,488,000, or 1.66% of loans, at September 30, 2016, and \$14,194,000, or 1.56% of loans, at December 31, 2016. In the following discussion, acquired loans from NW were recorded at fair value at the acquisition date and are not included in the tables and information below, see more information in Note 9 Loans in the Notes to Consolidated Financial Statements.

Changes in the allowance for loan losses were as follows:

In thousands	Nine Months Ended September 30, 2017	Year Ended December 31, 2016	Nine Months Ended September 30, 2016
Beginning balance - January 1	\$ 14,194	\$ 14,747	\$ 14,747
Provisions charged to operations			
Recoveries on charged-off loans	183	213	201
Loans charged-off	(272)	(766)	(460)
Ending balance	\$ 14,105	\$ 14,194	\$ 14,488

Loans past due 90 days and still accruing were \$1,626,000 and nonaccrual loans were \$6,695,000 as of September 30, 2017. \$3,434,000 of the nonaccrual balance at September 30, 2017, were in troubled debt restructured loans. \$3,939,000 of the impaired loans were accruing troubled debt restructured loans. Loans past due 90 days and still accruing were \$1,840,000 at September 30, 2016, while nonaccruals were \$3,693,000. \$395,000 of the nonaccrual balance at September 30, 2016, was in troubled debt restructured loans. \$6,657,000 of the impaired loans were accruing troubled debt restructured loans. Loans past due 90 days and still accruing were \$1,345,000 at December 31, 2016, while nonaccruals were \$4,502,000. \$377,000 of the nonaccrual balance at December 31, 2016, were in troubled debt restructured loans. \$7,443,000 of the impaired loans were accruing troubled debt restructured loans. Total additional loans classified as substandard (potential problem loans) at September 30, 2017, September 30, 2016, and December 31, 2016, were approximately \$8,029,000, \$2,386,000 and \$2,768,000, respectively.



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Information on nonaccrual loans, by collateral type rather than loan class, at September 30, 2017, as compared to December 31, 2016, is as follows:

Dollars in thousands	Number of Credit Relationships	Balance	Specific Loss Allocations	Current Year Charge-Offs	Location	Originated
<b>September 30, 2017</b>						
Owner occupied commercial real estate	9	\$ 4,474	\$ 117		In market	1995 - 2012
Investment/rental residential real estate	2	478	377		In market	2003 - 2011
Commercial and industrial	3	1,743	698		In market	2006 - 2015
<b>Total</b>	<b>14</b>	<b>\$ 6,695</b>	<b>\$ 1,192</b>			
<b>December 31, 2016</b>						
Commercial real estate construction	1	\$ 300	\$		In market	2014
Owner occupied commercial real estate	7	1,593			In market	1995 - 2012
Investment/rental residential real estate	3	483	333	61	In market	2003 - 2011
Commercial and industrial	3	2,126	599		In market	2006 - 2015
<b>Total</b>	<b>14</b>	<b>\$ 4,502</b>	<b>\$ 932</b>	<b>61</b>		

Management deemed it appropriate to provide this type of more detailed information by collateral type in order to provide additional detail on the loans.

All nonaccrual impaired loans are to borrowers located within the market area served by the Corporation in southcentral Pennsylvania and nearby areas of northern Maryland. All nonaccrual impaired loans were originated by ACNB's banking subsidiary, except for one participation loan discussed below, between 1995 and 2015 for purposes listed in the classifications in the table above.

Owner occupied commercial real estate at September 30, 2017, includes nine unrelated loan relationships, all of which except for a \$2,269,000 loan relationship for a retreat property, have balances of less than \$833,000 each, for which the real estate is collateral and is used in connection with a business enterprise that is suffering economic stress or is out of business. The retreat property loan originated in 2008 was added to nonaccrual in the second quarter of 2017 and is current with modified terms and is supported by adequate collateral. One of two improved parcels is being actively marketed for sale. Another property added in the second quarter of 2017 is an \$832,000 loan with modified terms and conditions originated in 2011 secured by a tourism related lodging real estate that was assigned \$117,000 in specific allocation based on a recent appraisal. The property is being actively marketed. A third property added in the second quarter 2017 is a \$638,000 loan relationship (\$485,000 in commercial and industrial and \$153,000 in owner occupied commercial real estate) with normal terms and conditions secured by a by construction business assets that was assigned \$181,000 in specific allocation based on bankruptcy filings. All assets including real estate are being liquidated with bankruptcy court supervision. The other loans in this category were originated between 1995 and 2012 and are business loans impacted by specific borrower credit situations. Most loans in this category are making principal payments. Collection efforts will continue unless it is deemed in the best interest of the Corporation to initiate foreclosure procedures. One loan was removed in 2017 after the borrower established an extended period of regular payments.

Investment/rental residential real estate at September 30, 2017, includes two loan relationships totaling \$478,000 for which the real estate is collateral and the purpose of which is for speculation, rental, or other non-owner occupied uses. One \$377,000 loan with multiple separate rental houses was added in the second quarter of 2016 and has a \$377,000 specific loss allocation based on a current appraisal adjusted for partial sales. One unrelated loan for approximately \$101,000 in this category at April 2015, was stayed from further foreclosure action by a bankruptcy filing.

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Included in impaired commercial and industrial loans at September 30, 2017, is a participation loan with standard terms and conditions including repayment from conversion of trade assets for a business in southcentral Pennsylvania in Chapter 11 bankruptcy that has a balance of \$390,000, which is net of \$1,326,000 in principal payments since it was moved to nonaccrual in the third quarter of 2014 after becoming delinquent. Liquidation of trade assets is in process. Besides trade assets, the loan is fully guaranteed by a government sponsored entity so no specific allocation was deemed to be necessary. An unrelated \$867,000 commercial loan relationship to finance a subcontract and change orders was moved to nonaccrual in the fourth quarter of 2016 with a \$517,000 specific allocation when part of the amount due to the subcontractor to perform on the loan was in dispute with the contractor and continues to be litigated.

The Corporation utilizes a systematic review of its loan portfolio on a quarterly basis in order to determine the adequacy of the allowance for loan losses. In addition, ACNB engages the services of an outside independent loan review function and sets the timing and coverage of loan reviews during the year. The results of this independent loan review are included in the systematic review of the loan portfolio. The allowance for loan losses consists of a component for individual loan impairment, primarily based on the loan's collateral fair value and expected cash flow. A watch list of loans is identified for evaluation based on internal and external loan grading and reviews. Loans other than those determined to be impaired are grouped into pools of loans with similar credit risk characteristics. These loans are evaluated as groups with allocations made to the allowance based on historical loss experience adjusted for current trends in delinquencies, trends in underwriting and oversight, concentrations of credit, and general economic conditions within the Corporation's trading area. The provision expense was based on the loans discussed above, as well as current trends in the watch list and the local economy as a whole. The charge-offs discussed elsewhere in this Management's Discussion and Analysis create the recent loss history experience and result in the qualitative adjustment which, in turn, affects the calculation of losses inherent in the portfolio. The lack of provision for loan losses for 2017 and 2016 was a result of the measurement of the adequacy of the allowance for loan losses at each period. More specifically, with the manageable level of nonaccrual loans and with substandard loans in the third quarter of 2017, no provision addition to the allowance was necessary in proportion to nonaccrual and substandard loans increase in accordance with management's belief that adequate collateralization generally exists for these loans in accordance with GAAP. Each quarter, the Corporation assesses risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors.

#### *Premises and Equipment*

During the quarter ended June 30, 2016, a building was sold and the Corporation is leasing back a portion of that building. In connection with these transactions, a gain of \$1,147,000 was realized, of which \$447,000 was recognized in the quarter ended June 30, 2016 and the remaining \$700,000 deferred for future recognition over the lease back term. A reduction of lease expense of \$53,000 was recognized in the first nine months of 2017. ACNB valued six buildings acquired from NW at \$8,624,000 at July 1, 2017.

#### *Foreclosed Assets Held for Resale*

Foreclosed assets held for resale consists of the fair value of real estate acquired through foreclosure on real estate loan collateral or the acceptance of ownership of real estate in lieu of the foreclosure process. These fair values, less estimated costs to sell, become the Corporation's new cost basis. Fair values are based on appraisals that consider the sales prices of similar properties in the proximate vicinity less estimated selling costs. The carrying value of real estate acquired through foreclosure totaled \$275,000 for three unrelated properties and borrowers at September 30, 2017, compared to \$256,000 for four unrelated properties and borrowers at December 31, 2016, three of which were disposed of in 2017. The increase in the carrying value was due to the two properties that were acquired from NW at fair value. All properties are being actively marketed. The Corporation expects to obtain and market additional foreclosed assets through the remainder of 2017; however, the total amount and timing is currently not certain.

#### *Deposits*

ACNB relies on deposits as a primary source of funds for lending activities with total deposits of \$1,311,884,000 as of September 30, 2017. Deposits increased by \$346,337,000, or 35.9%, from September 30, 2016, to September 30, 2017, and increased by \$344,263,000, or 35.6%, from December 31, 2016, to September 30, 2017. Deposits acquired from NW totaled \$293,333,000 on July 1, 2017. Deposits vary between quarters mostly reflecting different levels held by local government and school districts during different times of the year. ACNB's deposit pricing function employs a disciplined pricing approach based upon alternative funding rates, but also strives to price deposits to be competitive with relevant local competition, including a local government investment trust, credit unions and larger regional banks. During the recession and subsequent slow recovery, deposit growth mix experienced a shift to transaction accounts as customers put more value in liquidity

and FDIC insurance. Products, such as money market accounts and interest-bearing transaction accounts that had suffered declines in past years, continued with recovered balances; however, more recent trends suggest a return to more normal, lower balances. With persistent low market interest rates in a slow economy, ACNB's ability to maintain and add to its deposit base may be impacted by the reluctance of consumers to accept low rates and by competition willing to pay above market rates to attract market share. Alternatively, if rates rise rapidly and the equity markets recover, funds could leave the Corporation or be priced higher to maintain deposits.

### *Borrowings*

Short-term borrowings are comprised primarily of securities sold under agreements to repurchase and short-term borrowings from the FHLB. As of September 30, 2017, short-term borrowings were \$33,806,000, as compared to \$34,590,000 at December 31, 2016, and \$35,503,000 at September 30, 2016. Agreements to repurchase accounts are within the commercial and local government customer base and have attributes similar to core deposits. Investment securities are pledged in sufficient amounts to collateralize these agreements. In comparison to year-end 2016, repurchase agreement balances were down \$784,000, or 2.3%, due to changes in the cash flow position of ACNB's commercial and local government customer base and competition from non-bank sources. There were no short-term FHLB borrowings at September 30, 2017, December 31, 2016, and September 30, 2016. Short-term FHLB borrowings are used to even out funding from seasonality and daily fluctuations in the deposit base. Long-term borrowings consist of longer-term advances from the FHLB that provides term funding of loan assets, and Corporate borrowings that were acquired or originated in regards to the acquisition of NW. Long-term borrowings totaled \$96,850,000 at September 30, 2017, versus \$74,250,000 at December 31, 2016, and \$76,500,000 at September 30, 2016. The Corporation increased long-term borrowings 26.6% from September 30, 2016. A \$4.6 million borrowing from a local bank was made to fund cash payment to shareholders of the NW acquisition. \$10.8 million was added to FHLB borrowings to fund balance loan demand in excess of deposit growth. Laddered FHLB fixed-rate term advances were taken in to mature from 2017 to 2021 to reduce net liability sensitivity. In addition, \$5 million was subordinated debt acquired from NW. Please refer to the *Liquidity* discussion below for more information on the Corporation's ability to borrow.

### *Capital*

ACNB's capital management strategies have been developed to provide an appropriate rate of return, in the opinion of management, to stockholders, while maintaining its well-capitalized regulatory position in relationship to its risk exposure. Total stockholders' equity was \$153,256,000 at September 30, 2017, compared to \$120,061,000 at December 31, 2016, and \$120,754,000 at September 30, 2016. Stockholders' equity increased in the first nine months of 2017 by \$33,195,000 due to \$3,442,000 in earnings retained in capital and by \$29,118,000 in new shares issued.

The acquisition of NW resulted in 938,360 new ACNB shares issued to the NW shareholders valued at \$28,620,000.

A \$635,000 decrease in accumulated other comprehensive loss was a result of a net increase in the fair value of the investment portfolio and changes in the net funded position of the defined benefit pension plan. Other comprehensive income or loss is mainly caused by fixed-rate investment securities gaining or losing value in different interest rate environments and changes in the net funded position of the defined benefit pension plan.

The primary source of additional capital to ACNB is earnings retention, which represents net income less dividends declared. During the first nine months of 2017, ACNB earned \$7,271,000 and paid dividends of \$3,829,000 for a dividend payout ratio of 52.7%. During the first nine months of 2016, ACNB earned \$8,297,000 and paid dividends of \$3,627,000 for a dividend payout ratio of 43.7%.

ACNB Corporation has a Dividend Reinvestment and Stock Purchase Plan that provides registered holders of ACNB Corporation common stock with a convenient way to purchase additional shares of common stock by permitting participants in the plan to automatically reinvest cash dividends on all or a portion of the shares owned and to make quarterly voluntary cash payments under the terms of the plan. Participation in the plan is voluntary, and there are eligibility requirements to participate in the plan. Year-to-date September 30, 2017, 10,954 shares were issued under this plan with proceeds in the amount of \$258,000. Year-to-date September 30, 2016, 13,903 shares were issued under this plan with proceeds in the amount of \$338,000. Proceeds are used for general corporate purposes.

ACNB Corporation has a Restricted Stock plan available to selected officers and employees of the Bank, to advance the best interest of ACNB Corporation and its shareholders. The plan provides those persons who have responsibility for its growth with additional incentive by allowing them to acquire an ownership in ACNB Corporation and thereby encouraging them to contribute to the success of the Corporation. Year-to-date September 30, 2017, 6,193 shares were issued under this plan. Year-to-date September 30, 2016, 7,435 shares were issued under this plan. Proceeds are used for general corporate purposes.

ACNB is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on ACNB. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, ACNB must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and reclassifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require ACNB to maintain minimum amounts and ratios of total and Tier 1 capital to average assets. Management believes, as of September 30, 2017, and December 31, 2016, that ACNB's banking subsidiary met all minimum capital adequacy requirements to which it is subject and is categorized as "well capitalized" for regulatory purposes. There are no subsequent conditions or events that management believes have changed the banking subsidiary's category.

#### *Regulatory Capital Changes*

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

- a minimum ratio of common Tier 1 capital to risk-weighted assets of 4.5%;
- a minimum ratio of Tier 1 capital to risk-weighted assets of 6.0%;
- a minimum ratio of total capital to risk-weighted assets of 8.0%; and,
- a minimum leverage ratio of 4.0%.

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

Under the initially proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity Tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule. The Corporation elected to opt-out.

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

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

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



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

The Corporation calculated regulatory ratios as of September 30, 2017, and confirmed no material impact on the capital, operations, liquidity, and earnings of the Corporation and the banking subsidiary from the changes in the regulations.

#### *Risk-Based Capital*

The banking subsidiary's capital ratios are as follows:

	September 30, 2017	December 31, 2016	To Be Well Capitalized Under Prompt Corrective Action Regulations
Tier 1 leverage ratio (to average assets)	8.77%	8.82%	5.00%
Common Tier 1 capital ratio (to risk-weighted assets)	12.28%	12.96%	6.50%
Tier 1 risk-based capital ratio (to risk-weighted assets)	12.28%	12.96%	8.00%
Total risk-based capital ratio	13.53%	14.22%	10.00%

#### *Liquidity*

Effective liquidity management ensures the cash flow requirements of depositors and borrowers, as well as the operating cash needs of ACNB, are met.

ACNB's funds are available from a variety of sources, including assets that are readily convertible such as interest bearing deposits with banks, maturities and repayments from the securities portfolio, scheduled repayments of loans receivable, the core deposit base, and the ability to borrow from the FHLB. At September 30, 2017, ACNB's banking subsidiary had a borrowing capacity of approximately \$543,000,000 from the FHLB, of which \$439,000,000 was available. Because of various restrictions and requirements on utilizing the available balance, ACNB considers \$303,000,000 to be the practicable additional borrowing capacity, which is considered to be sufficient for operational needs. The FHLB system is self-capitalizing, member-owned, and its member banks' stock is not publicly traded. ACNB creates its borrowing capacity with the FHLB by granting a security interest in certain loan assets with requisite credit quality. ACNB has reviewed information on the FHLB system and the FHLB of Pittsburgh, and has concluded that they have the capacity and intent to continue to provide both operational and contingency liquidity. The FHLB of Pittsburgh instituted a requirement that a member's investment securities must be moved into a safekeeping account under FHLB control to be considered in the calculation of maximum borrowing capacity. The Corporation currently has securities in safekeeping at the FHLB of Pittsburgh; however, the safekeeping account is under the Corporation's control. As better contingent liquidity is maintained by keeping the securities under the Corporation's control, the Corporation has not moved the securities which, in effect, lowered the Corporation's maximum borrowing capacity. However, there is no practical reduction in borrowing capacity as the securities can be moved into the FHLB-controlled account promptly if they are needed for borrowing purposes.

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Another source of liquidity is securities sold under repurchase agreements to customers of ACNB's banking subsidiary totaling approximately \$33,806,000 and \$34,590,000 at September 30, 2017, and December 31, 2016, respectively. These agreements vary in balance according to the cash flow needs of customers and competing accounts at other financial organizations.

The liquidity of the parent company also represents an important aspect of liquidity management. The parent company's cash outflows consist principally of dividends to stockholders and corporate expenses. The main source of funding for the parent company is the dividends it receives from its subsidiaries. Federal and state banking regulations place certain legal restrictions and other practicable safety and soundness restrictions on dividends paid to the parent company from the subsidiary bank.

ACNB manages liquidity by monitoring projected cash inflows and outflows on a daily basis, and believes it has sufficient funding sources to maintain sufficient liquidity under varying degrees of business conditions.

### *Off-Balance Sheet Arrangements*

The Corporation is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and, to a lesser extent, standby letters of credit. At September 30, 2017, the Corporation had unfunded outstanding commitments to extend credit of approximately \$268,863,000 and outstanding standby letters of credit of approximately \$6,974,000. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements.

### *Market Risks*

Financial institutions can be exposed to several market risks that may impact the value or future earnings capacity of the organization. These risks involve interest rate risk, foreign currency exchange risk, commodity price risk, and equity market price risk. ACNB's primary market risk is interest rate risk. Interest rate risk is inherent because, as a financial institution, ACNB derives a significant amount of its operating revenue from purchasing funds (customer deposits and wholesale borrowings) at various terms and rates. These funds are then invested into earning assets (primarily loans and investments) at various terms and rates.

### **RECENT DEVELOPMENTS**

**DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (DODD-FRANK)** - In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. Dodd-Frank was intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created the Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally created a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank has had and will continue to have a significant impact on ACNB's business operations as its provisions take effect. It is expected that, as various implementing rules and regulations are released, they will increase ACNB's operating and compliance costs and could increase the banking subsidiary's interest expense. Among the provisions that are likely to affect ACNB are the following:

### *Holding Company Capital Requirements*

Dodd-Frank requires the Federal Reserve to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities are excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010, by a bank holding company with less than \$15 billion in assets as of December 31, 2009. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion, consistent with safety and soundness.

### *Deposit Insurance*

Dodd-Frank permanently increased the maximum deposit insurance amount for banks, savings institutions, and credit unions to \$250,000 per depositor. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Dodd-Frank also eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

### *Corporate Governance*

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

### *Prohibition Against Charter Conversions of Troubled Institutions*

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

### *Interstate Branching*

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

### *Limits on Interstate Acquisitions and Mergers*

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

### *Limits on Interchange Fees*

Dodd-Frank amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.

### *Consumer Financial Protection Bureau*

Dodd-Frank created the independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB, but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank allows borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

**ABILITY-TO-REPAY AND QUALIFIED MORTGAGE RULE** - Pursuant to Dodd-Frank as highlighted above, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine the consumer's ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making

the credit decision: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and, (8) credit history. Alternatively, the mortgage lender can originate qualified mortgages, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a qualified mortgage is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage, the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Loans which meet these criteria will be considered qualified mortgages and, as a result, generally protect lenders from fines or litigation in the event of foreclosure. Qualified mortgages that are higher-priced (e.g., subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not higher-priced (e.g., prime loans) are given a safe harbor of compliance. The impact of the final rule, and the subsequent amendments thereto, on the Corporation's lending activities and the Corporation's statements of income or condition has had little or no impact; however, management will continue to monitor the implementation of the rule for any potential effects on the Corporation's business.

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

## **SUPERVISION AND REGULATION**

### *Dividends*

ACNB is a legal entity separate and distinct from its subsidiary bank. ACNB's revenues, on a parent company only basis, result primarily from dividends paid to the Corporation by its subsidiaries. Federal and state laws regulate the payment of dividends by ACNB's subsidiary bank. For further information, please refer to *Regulation of Bank* below.

### *Regulation of Bank*

The operations of the subsidiary bank are subject to statutes applicable to banks chartered under the banking laws of Pennsylvania, to state nonmember banks of the Federal Reserve, and to banks whose deposits are insured by the FDIC. The subsidiary bank's operations are also subject to regulations of the Pennsylvania Department of Banking and Securities, Federal Reserve, and FDIC.

The Pennsylvania Department of Banking and Securities, which has primary supervisory authority over banks chartered in Pennsylvania, regularly examines banks in such areas as reserves, loans, investments, management practices, and other aspects of operations. The subsidiary bank is also subject to examination by the FDIC for safety and soundness, as well as consumer compliance. These examinations are designed for the protection of the subsidiary bank's depositors rather than ACNB's stockholders. The subsidiary bank must file quarterly and annual reports to the Federal Financial Institutions Examination Council, or FFIEC.

### *Monetary and Fiscal Policy*

ACNB and its subsidiary bank are affected by the monetary and fiscal policies of government agencies, including the Federal Reserve and FDIC. Through open market securities transactions and changes in its discount rate and reserve requirements, the Board of Governors of the Federal Reserve exerts considerable influence over the cost and availability of funds for lending and investment. The nature and impact of monetary and fiscal policies on future business and earnings of ACNB cannot be predicted at this time. From time to time, various federal and state legislation is proposed that could result in additional regulation of, and restrictions on, the business of ACNB and the subsidiary bank, or otherwise change the business environment. Management cannot predict whether any of this legislation will have a material effect on the business of ACNB.

**ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Management monitors and evaluates changes in market conditions on a regular basis. Based upon the most recent review, management has determined that there have been no material changes in market risks since year-end 2016. For further discussion of year-end information, please refer to the Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

**ITEM 4 - CONTROLS AND PROCEDURES**

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Corporation carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Corporation's disclosure controls and procedures are effective in timely alerting them to material information relating to the Corporation (including its consolidated subsidiaries) required to be included in periodic SEC filings.



Disclosure controls and procedures are Corporation controls and other procedures that are designed to ensure that information required to be disclosed by the Corporation in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There were no changes in the Corporation's internal control over financial reporting during the quarterly period ended September 30, 2017, that have materially affected, or are reasonably likely to materially affect, the internal control over financial reporting.

**PART II - OTHER INFORMATION**

**ACNB CORPORATION**

**ITEM 1 - LEGAL PROCEEDINGS**

As of September 30, 2017, there were no material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which ACNB or its subsidiaries are a party or by which any of their property is the subject, which could have a material adverse effect on ACNB or its subsidiaries or their results of operations. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Corporation or its subsidiaries by governmental authorities.

**ITEM 1A - RISK FACTORS**

Management has reviewed the risk factors that were previously disclosed in the Annual Report on Form 10-K for the fiscal year ended December 31, 2016. There are no material changes in the risk factors as previously disclosed in the Form 10-K.

**ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On November 3, 2008, the Corporation announced a plan to purchase up to 120,000 shares of its outstanding common stock. There were no treasury shares purchased under this plan during the quarter ended September 30, 2017. The maximum number of shares that may yet be purchased under this stock repurchase plan is 57,400.

On May 5, 2009, stockholders approved and ratified the ACNB Corporation 2009 Restricted Stock Plan, effective as of February 24, 2009, in which awards shall not exceed, in the aggregate, 200,000 shares of common stock. As of September 30, 2017, there were 19,301 shares of common stock granted as restricted stock awards to employees of the subsidiary bank. The maximum number of shares that may yet be granted under the restricted stock plan is 180,699. The Corporation's Registration Statement under the Securities Act of 1933 on Form S-8 for the ACNB Corporation 2009 Restricted Stock Plan was filed with the Securities and Exchange Commission on January 4, 2013.

On May 5, 2009, stockholders approved and adopted the amendment to the Articles of Incorporation of ACNB Corporation to authorize up to 20,000,000 shares of preferred stock, par value \$2.50 per share. As of September 30, 2017, there were no issued or outstanding shares of preferred stock.

On January 24, 2011, the ACNB Corporation Dividend Reinvestment and Stock Purchase Plan was introduced for stockholders of record. This plan provides registered holders of ACNB Corporation common stock with a convenient way to purchase additional shares of common stock by permitting participants in the plan to automatically reinvest cash dividends on all or a portion of the shares owned and to make quarterly voluntary cash payments under the terms of the plan. Participation in the plan is voluntary, and there are eligibility requirements to participate in

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the plan. As of September 30, 2017, there were 133,641 shares of common stock issued through the ACNB Corporation Dividend Reinvestment and Stock Purchase Plan.

**ITEM 3 - DEFAULTS UPON SENIOR SECURITIES - NOTHING TO REPORT.**

**ITEM 4 - MINE SAFETY DISCLOSURES - NOT APPLICABLE.**

**ITEM 5 - OTHER INFORMATION - NOTHING TO REPORT.**

**ITEM 6 - EXHIBITS**

The following exhibits are included in this report:

- Exhibit 2.1 Agreement and Plan of Reorganization by and among ACNB Corporation, ACNB South Acquisition Subsidiary, LLC, ACNB Bank, New Windsor Bancorp, Inc., and New Windsor State Bank dated as of November 21, 2016, as amended. (Incorporated by reference to Annex A of the Registrant's Registration Statement No. 333-215914 on Form S-4, filed with the Commission on February 6, 2017.) Schedules are omitted; the Registrant agrees to furnish copies of Schedules to the Securities and Exchange Commission upon request.
- Exhibit 2.2 Amendment No. 2 to Agreement and Plan of Reorganization by and among ACNB Corporation, ACNB South Acquisition Subsidiary, LLC, ACNB Bank, New Windsor Bancorp, Inc., and New Windsor State Bank dated as of April 18, 2017. (Incorporated by reference to Exhibit 2.2 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2017, filed with the Commission on August 4, 2017.)
- Exhibit 3(i) Articles of Incorporation of ACNB Corporation, as amended. (Incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 2, 2009.)
- Exhibit 3(ii) Bylaws of ACNB Corporation, as amended. (Incorporated by reference to Exhibit 3.2 of the Registrant's Current Report on Form 8-K, filed with the Commission on February 4, 2013.)
- Exhibit 10.1 ACNB Corporation, ACNB Acquisition Subsidiary LLC, and Russell Insurance Group, Inc. Stock Purchase Agreement. (Incorporated by reference to Exhibit 10.2 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Commission on March 15, 2005.)
- Exhibit 10.2 Salary Continuation Agreement Applicable to Ronald L. Hankey. (Incorporated by reference to Exhibit 10.2 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)
- Exhibit 10.3 Amended and Restated Executive Supplemental Life Insurance Plan Applicable to Thomas A. Ritter, David W. Cathell, Lynda L. Glass and James P. Helt. (Incorporated by reference to Exhibit 10.3 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2014, filed with the Commission on March 6, 2015.)
- Exhibit 10.4 Amended and Restated Director Supplemental Life Insurance Plan Applicable to Richard L. Alloway II, Frank Elsner III, Scott L. Kelley, James J. Lott, Robert W. Miller, Donna M. Newell, J. Emmett Patterson, Daniel W. Potts, Marian B. Schultz, David L. Sites, Alan J. Stock and James E. Williams. (Incorporated by reference to Exhibit 10.4 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2014, filed with the Commission on March 6, 2015.)
- Exhibit 10.5 Amended and Restated Director Deferred Fee Plan Applicable to Richard L. Alloway II, Frank Elsner III, Scott L. Kelley, James J. Lott, Robert W. Miller, Donna M. Newell, J. Emmett Patterson, Marian B. Schultz, David L. Sites, Alan J. Stock and James E. Williams. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on January 6, 2012.)
- Exhibit 10.6 ACNB Bank Salary Savings Plan. (Incorporated by reference to Exhibit 10.6 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009, filed with the Commission on March 12, 2010.)
- Exhibit 10.7 Group Pension Plan for Employees of ACNB Bank. (Incorporated by reference to Exhibit 10.7 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2012, filed with the Commission on May 4, 2012.)
- Exhibit 10.8 Complete Settlement Agreement and General Release made among ACNB Corporation, Adams County National Bank and John W. Krichten effective June 13, 2006. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 15, 2006.)



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Exhibit 10.9	<u>Amended and Restated Employment Agreement between ACNB Corporation, Adams County National Bank and Thomas A. Ritter dated as of December 31, 2008. (Incorporated by reference to Exhibit 10.9 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)</u>
Exhibit 10.10	<u>Amended and Restated Employment Agreement between ACNB Corporation, Adams County National Bank and Lynda L. Glass dated as of December 31, 2008. (Incorporated by reference to Exhibit 10.10 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)</u>
Exhibit 10.11	<u>Employment Agreement between ACNB Corporation, Russell Insurance Group, Inc. and Frank C. Russell, Jr. dated as of January 13, 2011. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on January 19, 2011.)</u>
Exhibit 10.12	<u>Employment Agreement between ACNB Corporation, Adams County National Bank and David W. Cathell dated as of April 17, 2009. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 23, 2009.)</u>
Exhibit 10.13	<u>2009 Restricted Stock Plan. (Incorporated by reference to Appendix C of the Registrant's Proxy Statement on Schedule 14A, filed with the Commission on March 25, 2009.)</u>
Exhibit 10.14	<u>Salary Continuation Agreement by and between ACNB Bank and Thomas A. Ritter dated as of March 28, 2012. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 3, 2012.)</u>
Exhibit 10.15	<u>Salary Continuation Agreement by and between ACNB Bank and Lynda L. Glass dated as of March 28, 2012. (Incorporated by reference to Exhibit 99.2 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 3, 2012.)</u>
Exhibit 10.16	<u>Salary Continuation Agreement by and between ACNB Bank and David W. Cathell dated as of March 28, 2012. (Incorporated by reference to Exhibit 99.3 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 3, 2012.)</u>
Exhibit 10.17	<u>Amended and Restated 2001 Salary Continuation Agreement by and between ACNB Bank and Thomas A. Ritter dated as of March 28, 2012. (Incorporated by reference to Exhibit 99.4 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 3, 2012.)</u>
Exhibit 10.18	<u>Amended and Restated 1996 Salary Continuation Agreement by and between ACNB Bank and Lynda L. Glass dated as of March 28, 2012. (Incorporated by reference to Exhibit 99.5 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 3, 2012.)</u>
Exhibit 10.19	<u>Employment Agreement between Adams County National Bank and James P. Helt dated as of April 15, 2009. (Incorporated by reference to Exhibit 10.19 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013, filed with the Commission on March 7, 2014.)</u>
Exhibit 10.20	<u>Salary Continuation Agreement by and between ACNB Bank and James P. Helt dated as of March 28, 2012. (Incorporated by reference to Exhibit 10.20 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013, filed with the Commission on March 7, 2014.)</u>
Exhibit 10.21	<u>ACNB Bank Variable Compensation Plan effective January 1, 2014 and amended July 1, 2016. (Incorporated by reference to Exhibit 10.21 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016, filed with the Commission on July 29, 2016.)</u>
Exhibit 10.22	<u>Form of ACNB Bank Variable Compensation Plan Restricted Stock Agreement dated as of June 22, 2015. (Incorporated by reference to Exhibit 99.2 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 25, 2015.)</u>

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Exhibit 10.23	<u>Form of ACNB Bank Variable Compensation Plan Restricted Stock Agreement dated as of June 15, 2016. (Incorporated by reference to Exhibit 99.3 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 21, 2016.)</u>
Exhibit 10.24	<u>First Amendment to Employment Agreement by and between ACNB Corporation, ACNB Bank and James P. Helt as of December 27, 2016. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on December 28, 2016.)</u>
Exhibit 10.25	<u>First Amendment to the Amended and Restated Employment Agreement by and between ACNB Corporation, ACNB Bank and Lynda L. Glass as of December 27, 2016. (Incorporated by reference to Exhibit 99.2 of the Registrant's Current Report on Form 8-K, filed with the Commission on December 28, 2016.)</u>
Exhibit 10.26	<u>First Amendment to Employment Agreement by and between ACNB Corporation, ACNB Bank and David W. Cathell as of December 27, 2016. (Incorporated by reference to Exhibit 99.3 of the Registrant's Current Report on Form 8-K, filed with the Commission on December 28, 2016.)</u>
Exhibit 10.27	<u>Form of ACNB Bank Variable Compensation Plan Restricted Stock Agreement dated as of June 15, 2017. (Incorporated by reference to Exhibit 99.3 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 21, 2017.)</u>
Exhibit 11	<u>Statement re Computation of Earnings. (Incorporated by reference to page 11 of this Form 10-Q.)</u>
Exhibit 14	Code of Ethics. (A copy of the Code of Ethics is available under the Corporate Governance Documents section of the Registrant's website at <a href="http://www.acnb.com">www.acnb.com</a> .)
Exhibit 18	<u>Preferability Letter from ParenteBeard LLC dated as of August 3, 2012. (Incorporated by reference to Exhibit 18 of the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, filed with the Commission on August 3, 2012.)</u>
Exhibit 31.1	<u>Chief Executive Officer Certification of Quarterly Report on Form 10-Q.</u>
Exhibit 31.2	<u>Chief Financial Officer Certification of Quarterly Report on Form 10-Q.</u>
Exhibit 32.1	<u>Chief Executive Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
Exhibit 32.2	<u>Chief Financial Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
Exhibit 101.LAB	XBRL Taxonomy Extension Label Linkbase.
Exhibit 101.PRE	XBRL Taxonomy Extension Presentation Linkbase.
Exhibit 101.INS	XBRL Instance Document.
Exhibit 101.SCH	XBRL Taxonomy Extension Schema.
Exhibit 101.CAL	XBRL Taxonomy Extension Calculation Linkbase.
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ACNB CORPORATION (Registrant)**

Date: November 3, 2017

/s/ James P. Helt  
James P. Helt  
President & Chief Executive Officer

/s/ David W. Cathell  
David W. Cathell  
Executive Vice President/Treasurer &  
Chief Financial Officer (Principal Financial Officer)