

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
May 10, 2017

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10 Q

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

For the quarterly period ended March 31, 2017  
Or

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

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

Commission file number 0 13222

CITIZENS FINANCIAL SERVICES, INC.  
(Exact name of registrant as specified in its charter)

PENNSYLVANIA 23 2265045  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

15 South Main Street  
Mansfield, Pennsylvania 16933  
(Address of principal executive offices)(Zip Code)

Registrant's telephone number, including area code: (570) 662 2121

N/A

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(Former Name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports 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, a 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 \_\_\_\_\_ Smaller  
reporting company \_\_\_\_\_  
(Do not check if a 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 outstanding shares of the Registrant's Common Stock, as of May 2, 2017, was 3,320,366.

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Citizens Financial Services, Inc.  
Form 10-Q

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CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

(in thousands except share data)	March 31 2017	December 31 2016
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$13,587	\$16,854
Interest-bearing	1,210	900
Total cash and cash equivalents	14,797	17,754
Interest bearing time deposits with other banks	6,708	6,955
Available-for-sale securities	281,773	314,017
Loans held for sale	1,581	1,827
Loans (net of allowance for loan losses: 2017, \$9,405 and 2016, \$8,886)	835,902	790,725
Premises and equipment	16,949	17,030
Accrued interest receivable	3,618	4,089
Goodwill	21,089	21,089
Bank owned life insurance	26,389	26,223
Other intangibles	2,012	2,096
Receivable for settlement of security sales	1,297	7,759
Other assets	12,409	13,454
<b>TOTAL ASSETS</b>	<b>\$1,224,524</b>	<b>\$1,223,018</b>
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$157,426	\$147,425
Interest-bearing	880,183	858,078
Total deposits	1,037,609	1,005,503
Borrowed funds	46,836	79,662
Accrued interest payable	612	720
Other liabilities	14,511	13,865
<b>TOTAL LIABILITIES</b>	<b>1,099,568</b>	<b>1,099,750</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred Stock		
\$1.00 par value; authorized 3,000,000 shares March 31, 2017 and December 31, 2016; none issued in 2017 or 2016	-	-
Common stock		
\$1.00 par value; authorized 15,000,000 shares; issued 3,704,375 at March 31, 2017 and December 31, 2016	3,704	3,704
Additional paid-in capital	42,256	42,250
Retained earnings	93,172	91,278
Accumulated other comprehensive loss	(1,421 )	(1,392 )
Treasury stock, at cost: 388,190 shares at March 31, 2017 and 384,671 shares at December 31, 2016	(12,755 )	(12,572 )

TOTAL STOCKHOLDERS' EQUITY	124,956	123,268
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$1,224,524	\$1,223,018

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

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CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF INCOME  
(UNAUDITED)

(in thousands, except share and per share data)	Three Months Ended	
	2017	2016
INTEREST INCOME:		
Interest and fees on loans	\$9,717	\$8,596
Interest-bearing deposits with banks	35	71
Investment securities:		
Taxable	804	944
Nontaxable	668	771
Dividends	76	80
TOTAL INTEREST INCOME	11,300	10,462
INTEREST EXPENSE:		
Deposits	1,045	1,074
Borrowed funds	258	183
TOTAL INTEREST EXPENSE	1,303	1,257
NET INTEREST INCOME	9,997	9,205
Provision for loan losses	615	135
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	9,382	9,070
NON-INTEREST INCOME:		
Service charges	1,058	1,102
Trust	221	196
Brokerage and insurance	191	209
Gains on loans sold	101	46
Investment securities gains, net	172	27
Earnings on bank owned life insurance	166	170
Other	126	166
TOTAL NON-INTEREST INCOME	2,035	1,916
NON-INTEREST EXPENSES:		
Salaries and employee benefits	4,319	3,882
Occupancy	527	445
Furniture and equipment	139	157
Professional fees	310	287
FDIC insurance	105	157
Pennsylvania shares tax	281	150
Amortization of intangibles	76	82
ORE expenses	90	92
Other	1,344	1,660
TOTAL NON-INTEREST EXPENSES	7,191	6,912
Income before provision for income taxes	4,226	4,074
Provision for income taxes	923	791
NET INCOME	\$3,303	\$3,283
PER COMMON SHARE DATA:		
Net Income - Basic	\$1.00	\$0.98
Net Income - Diluted	\$1.00	\$0.98
Cash Dividends Paid	\$0.425	\$0.411

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Number of shares used in computation - basic	3,313,616	3,356,573
Number of shares used in computation - diluted	3,313,636	3,356,573

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

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CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME  
(UNAUDITED)

(in thousands)	Three Months Ended	
	March 31,	
	2017	2016
Net income	\$3,303	\$3,283
Other comprehensive income (loss):		
Change in unrealized gains on available for sale securities	70	1,694
Income tax effect	(24 )	(577 )
Change in unrecognized pension cost	60	61
Income tax effect	(21 )	(21 )
Less: Reclassification adjustment for investment security gains included in net income	(172)	(27 )
Income tax effect	58	9
Other comprehensive income (loss), net of tax	(29 )	1,139
Comprehensive income	\$3,274	\$4,422

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



CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)	Three Months Ended March 31,	
(in thousands)	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$3,303	\$3,283
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	615	135
Depreciation and amortization	108	76
Amortization and accretion of investment securities	382	567
Deferred income taxes	(174 )	(115 )
Investment securities gains, net	(172 )	(27 )
Earnings on bank owned life insurance	(166 )	(170 )
Originations of loans held for sale	(4,727 )	(3,913 )
Proceeds from sales of loans held for sale	5,075	3,005
Realized gains on loans sold	(101 )	(46 )
Decrease in accrued interest receivable	471	115
Decrease in accrued interest payable	(108 )	(74 )
Other, net	1,801	(467 )
Net cash provided by operating activities	6,307	2,369
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Available-for-sale securities:		
Proceeds from sales	18,766	5,020
Proceeds from maturity and principal repayments	29,858	9,757
Purchase of securities	(11,039)	(25,840)
Purchase of interest bearing time deposits with other banks	(746 )	-
Proceeds from redemption of regulatory stock	2,617	112
Purchase of regulatory stock	(1,288 )	-
Net increase in loans	(45,880)	(4,454 )
Purchase of premises and equipment	(113 )	(166 )
Proceeds from sale of interest bearing time deposits with other banks	750	-
Proceeds from sale of foreclosed assets held for sale	125	289
Net cash used in investing activities	(6,950 )	(15,282)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	32,106	29,780
Proceeds from long-term borrowings	2	2
Net increase in short-term borrowed funds	(32,828)	(1,637 )
Purchase of treasury and restricted stock	(396 )	(860 )
Dividends paid	(1,198 )	(1,377 )
Net cash (used) provided by financing activities	(2,314 )	25,908
Net (decrease) increase in cash and cash equivalents	(2,957 )	12,995
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>17,754</b>	<b>24,384</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$14,797</b>	<b>\$37,379</b>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Interest paid	\$1,411	\$1,331
Income taxes paid	\$-	\$450
Loans transferred to foreclosed property	\$307	\$64

Investments and time deposits sold and not settled	\$1,297	\$-
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The accompanying notes are an integral part of these unaudited consolidated financial statements.

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CITIZENS FINANCIAL SERVICES, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

Note 1 - Basis of Presentation

Citizens Financial Services, Inc. (individually and collectively with its direct and indirect subsidiaries, the "Company") is a Pennsylvania corporation and the holding company of its wholly owned subsidiary, First Citizens Community Bank (the "Bank"), and of the Bank's wholly owned subsidiary, First Citizens Insurance Agency, Inc. ("First Citizens Insurance").

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") and in conformity with U.S. generally accepted accounting principles. Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. Certain of the prior year amounts have been reclassified to conform with the current year presentation. Such reclassifications had no effect on net income or stockholders' equity. All material inter company balances and transactions have been eliminated in consolidation.

In the opinion of management of the Company, the accompanying interim financial statements at March 31, 2017 and for the periods ended March 31, 2017 and 2016 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the periods. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. The financial performance reported for the Company for the three month period ended March 31, 2017 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Note 2 - Earnings per Share

The following table sets forth the computation of earnings per share. Earnings per share calculations give retroactive effect to stock dividends declared by the Company.

	Three months ended March 31,	
	2017	2016
Net income applicable to common stock	\$3,303,000	\$3,283,000
Basic earnings per share computation		
Weighted average common shares outstanding	3,313,616	3,356,573
Earnings per share - basic	\$1.00	\$0.98
Diluted earnings per share computation		
Weighted average common shares outstanding for basic earnings per share	3,313,616	3,356,573
Add: Dilutive effects of restricted stock	20	-
Weighted average common shares outstanding for dilutive earnings per share	3,313,636	3,356,573
Earnings per share - diluted	\$1.00	\$0.98

For the three months ended March 31, 2017 and 2016, there were 2,087 and 5,325 shares, respectively, related to the restricted stock plan that were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had per share prices ranging from \$49.87-\$53.15 for the three month period ended March

31, 2017 and per share prices ranging from \$46.69-\$53.15 for the three month period ended March 31, 2016.

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## Note 3 - Income Tax Expense

Income tax expense is less than the amount calculated using the statutory tax rate, primarily as a result of tax-exempt income earned from state and municipal securities and loans and investments in affordable housing tax credits.

## Investments in Qualified Affordable Housing Projects

As of March 31, 2017 and December 31, 2016, the Company was invested in four partnerships that provide affordable housing. The balance of the investments, which is included within other assets in the Consolidated Balance Sheet, was \$660,000 and \$700,000 as of March 31, 2017 and December 31, 2016, respectively. Investments purchased prior to January 1, 2015, are accounted for utilizing the effective yield method. As of March 31, 2017, the Company had \$811,000 of tax credits remaining that will be recognized over 5.75 years. Tax credits of \$35,000 and \$50,000 were recognized as a reduction of tax expense during the three months ended March 31, 2017 and 2016, respectively. Amortization of the investment included in other expenses on the Consolidated Statement of Income was \$40,000 and \$65,000 during the three months ended March 31, 2017 and 2016, respectively.

## Note 4 – Investments

The amortized cost, gross unrealized gains and losses, and fair value of investment securities at March 31, 2017 and December 31, 2016 were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2017				
Available-for-sale securities:				
U.S. agency securities	\$ 147,624	\$ 297	\$ (263	) \$ 147,658
Obligations of state and political subdivisions	87,082	1,500	(339	) 88,243
Corporate obligations	3,000	95	-	3,095
Mortgage-backed securities in government sponsored entities	41,292	82	(256	) 41,118
Equity securities in financial institutions	899	760	-	1,659
Total available-for-sale securities	\$ 279,897	\$ 2,734	\$ (858	) \$ 281,773
December 31, 2016				
Available-for-sale securities:				
U.S. agency securities	\$ 170,276	\$ 407	\$ (269	) \$ 170,414
U.S. treasury securities	2,999	1	-	3,000
Obligations of state and political subdivisions	95,956	1,463	(493	) 96,926
Corporate obligations	3,000	50	-	3,050
Mortgage-backed securities in government sponsored entities	37,987	88	(347	) 37,728
Equity securities in financial institutions	1,821	1,078	-	2,899
Total available-for-sale securities	\$ 312,039	\$ 3,087	\$ (1,109	) \$ 314,017

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, which individual securities have been in a continuous unrealized loss position, at March 31, 2017 and December 31, 2016 (in thousands). As of March 31, 2017, the Company owned 80 securities whose fair value was

less than their cost basis.

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	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
March 31, 2017						
U.S. agency securities	\$61,938	\$ (263 )	\$-	\$ -	\$61,938	\$ (263 )
Obligations of state and political subdivisions	18,733	(279 )	2,117	(60 )	20,850	(339 )
Mortgage-backed securities in government sponsored entities	23,028	(221 )	3,159	(35 )	26,187	(256 )
Total securities	\$103,699	\$ (763 )	\$5,276	\$ (95 )	\$108,975	\$ (858 )
December 31, 2016						
U.S. agency securities	\$50,947	\$ (269 )	\$-	\$ -	\$50,947	\$ (269 )
Obligations of states and political subdivisions	28,398	(472 )	767	(21 )	29,165	(493 )
Mortgage-backed securities in government sponsored entities	26,717	(330 )	753	(17 )	27,470	(347 )
Total securities	\$106,062	\$ (1,071 )	\$1,520	\$ (38 )	\$107,582	\$ (1,109 )

As of March 31, 2017 and December 31, 2016, the Company's investment securities portfolio contained unrealized losses on agency securities issued or backed by the full faith and credit of the United States government or are generally viewed as having the implied guarantee of the U.S. government, obligations of states and political subdivisions and mortgage backed securities issued by government sponsored entities. For fixed maturity investments management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an impairment loss unless sufficient evidence is available that the decline is not other than temporary and a recovery period can be predicted. The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not other than temporary and is the result of interest rate changes, sector credit rating changes, or issuer-specific rating changes that are not expected to result in the non-collection of principal and interest during the period.

Proceeds from sales of securities available-for-sale for the three months ended March 31, 2017 and 2016 were \$18,766,000 and \$5,020,000, respectively. The gross gains and losses were as follows (in thousands):

	Three Months Ended March 31,	
	2017	2016
Gross gains	\$ 172	\$ 27

Gross losses	-	-
Net gains	\$172	\$27

Investment securities with an approximate carrying value of \$206.5 million and \$206.3 million at March 31, 2017 and December 31, 2016, respectively, were pledged to secure public funds and certain other deposits.

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Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and fair value of debt securities (excludes equity securities) at March 31, 2017, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Fair Value
Available-for-sale debt securities:		
Due in one year or less	\$ 36,081	\$36,288
Due after one year through five years	141,531	142,341
Due after five years through ten years	38,172	38,283
Due after ten years	63,214	63,202
Total	\$ 278,998	\$280,114

Note 5 – Loans

The Company grants loans primarily to customers throughout north central, central and south central Pennsylvania and the southern tier of New York. Although the Company had a diversified loan portfolio at March 31, 2017 and December 31, 2016, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions. The following table summarizes the primary segments of the loan portfolio and how those segments are analyzed within the allowance for loan losses as of March 31, 2017 and December 31, 2016 (in thousands):

	Total Loans	Individually evaluated for impairment	Loans acquired with deteriorated credit quality	Collectively evaluated for impairment
March 31, 2017				
Real estate loans:				
Residential	\$203,817	\$ 945	\$ 35	\$ 202,837
Commercial	267,097	6,347	1,965	258,785
Agricultural	156,299	3,476	737	152,086
Construction	26,118	-	-	26,118
Consumer	10,508	2	1	10,505
Other commercial loans	59,800	5,281	863	53,656
Other agricultural loans	24,227	1,612	-	22,615
State and political subdivision loans	97,441	-	-	97,441
Total	845,307	17,663	3,601	824,043
Allowance for loan losses	9,405	404	-	9,001
Net loans	\$835,902	\$ 17,259	\$ 3,601	\$ 815,042
December 31, 2016				
Real estate loans:				
Residential	\$207,423	\$ 957	\$ 35	\$ 206,431
Commercial	252,577	5,742	1,969	244,866
Agricultural	123,624	3,346	738	119,540
Construction	25,441	-	-	25,441
Consumer	11,005	-	4	11,001
Other commercial loans	58,639	5,994	621	52,024
Other agricultural loans	23,388	1,654	-	21,734

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State and political subdivision loans	97,514	-	-	97,514
Total	799,611	17,693	3,367	778,551
Allowance for loan losses	8,886	487	-	8,399
Net loans	\$790,725	\$ 17,206	\$ 3,367	\$ 770,152

Purchased loans acquired in The First National Bank of Fredericksburg (FNB) acquisition were recorded at fair value on their purchase date without a carryover of the related allowance for loan losses.

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Upon acquisition, the Company evaluated whether an acquired loan was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired ("PCI") loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. Based upon management's review, there were no material increases or decreases in the expected cash flows of these loans between December 11, 2015 (the "acquisition date") and March 31, 2017. The fair value of PCI loans, on the acquisition date, was determined, primarily based on the fair value of the loans' collateral. The carrying value of PCI loans was \$3,601,000 and \$3,367,000 at March 31, 2017 and December 31, 2016, respectively.

The carrying value of the PCI loans was determined by projected discounted contractual cash flows.

Changes in the accretable yield for PCI loans were as follows for the three months ended March 31, 2017 and 2016, respectively (in thousands):

	March 31, 2017	March 31, 2016
Balance at beginning of period	\$ 389	\$ 637
Accretion	(114)	(86 )
Balance at end of period	\$ 275	\$ 551

The following table presents additional information regarding loans acquired with specific evidence of deterioration in credit quality under ASC 310-30 (in thousands):

	March 31, 2017	December 31, 2016
Outstanding balance	\$ 6,688	\$ 6,487
Carrying amount	3,601	3,367

The segments of the Company's loan portfolio are disaggregated into classes to a level that allows management to monitor risk and performance. Residential real estate mortgages consist primarily of 15 to 30 year first mortgages on residential real estate, while residential real estate home equity loans are consumer purpose installment loans or lines of credit with terms of 15 years or less secured by a mortgage which is often a second lien on residential real estate. Commercial real estate loans are business purpose loans secured by a mortgage on commercial real estate. Agricultural real estate loans are loans secured by a mortgage on real estate used in agriculture production. Construction real estate loans are loans secured by residential or commercial real estate used during the construction phase of residential and commercial projects. Consumer loans are typically unsecured or primarily secured by assets other than real estate and overdraft lines of credit are typically secured by customer deposit accounts. Other commercial loans are loans for commercial purposes primarily secured by non-real estate collateral. Other agricultural loans are loans for agricultural purposes primarily secured by non-real estate collateral. State and political subdivision loans are loans to state and local municipalities for capital and operating expenses or tax free loans used to finance commercial development.

Management considers other commercial loans, other agricultural loans, state and political subdivision loans, commercial real estate loans and agricultural real estate loans which are 90 days or more past due to be impaired. Management will also consider a loan impaired based on other factors it becomes aware of, including the customer's results of operations and cash flows or if the loan is modified in a troubled debt restructuring. In addition, certain residential mortgages, home equity and consumer loans that are cross collateralized with commercial relationships that are determined to be impaired may also be classified as impaired. Impaired loans are analyzed to determine if it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If

management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allocation of the allowance for loan losses or a charge-off to the allowance for loan losses.

The following table includes the recorded investment and unpaid principal balances for impaired financing receivables by class, excluding PCI loans, with the associated allowance amount, if applicable (in thousands):

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March 31, 2017	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
Real estate loans:					
Mortgages	\$ 949	\$ 568	\$ 322	\$ 890	\$ 28
Home Equity	55	-	55	55	10
Commercial	8,628	5,937	410	6,347	47
Agricultural	3,487	2,146	1,330	3,476	103
Construction	-	-	-	-	-
Consumer	2	-	2	2	2
Other commercial loans	5,797	4,806	475	5,281	195
Other agricultural loans	1,612	1,593	19	1,612	19
State and political subdivision loans	-	-	-	-	-
Total	\$ 20,530	\$ 15,050	\$ 2,613	\$ 17,663	\$ 404

December 31, 2016

Real estate loans:					
Mortgages	\$ 953	\$ 570	\$ 330	\$ 900	\$ 22
Home Equity	57	-	57	57	10
Commercial	7,958	5,697	45	5,742	45
Agricultural	3,347	2,000	1,347	3,347	54
Construction	-	-	-	-	-
Consumer	-	-	-	-	-
Other commercial loans	6,159	5,135	859	5,994	326
Other agricultural loans	1,653	1,629	24	1,653	30
State and political subdivision loans	-	-	-	-	-
Total	\$ 20,127	\$ 15,031	\$ 2,662	\$ 17,693	\$ 487

The following tables includes the average balance of impaired financing receivables by class and the income recognized on these receivables for the three month periods ended March 31, 2017 and 2016(in thousands):

	For the Three Months Ended			March 31, 2016		
	March 31, 2017		Interest	March 31, 2016		Interest
	Average Recorded Investment	Interest Recognized	Income Recognized Cash Basis	Average Recorded Investment	Interest Recognized	Income Recognized Cash Basis
Real estate loans:						
Mortgages	\$ 894	\$ 3	\$ -	\$ 391	\$ 4	\$ -
Home Equity	56	1	-	60	1	-
Commercial	5,793	24	3	6,179	26	-
Agricultural	3,382	31	-	165	2	-
Construction	-	-	-	-	-	-
Consumer	1	-	-	-	-	-
Other commercial loans	5,597	40	10	5,952	66	1
Other agricultural loans	1,627	23	-	105	1	-
State and political						

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subdivision loans	-	-	-	-	-	-
Total	\$17,350	\$ 122	\$ 13	\$12,852	\$ 100	\$ 1

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## Credit Quality Information

For commercial real estate, agricultural real estate, construction, other commercial, other agricultural and state and political subdivision loans, management uses a nine grade internal risk rating system to monitor credit quality. The first five categories are considered not criticized and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The definitions of each rating are defined below:

Pass (Grades 1-5) – These loans are to customers with credit quality ranging from an acceptable to very high quality and are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.

Special Mention (Grade 6) – This loan grade is in accordance with regulatory guidance and includes loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard (Grade 7) – This loan grade is in accordance with regulatory guidance and includes loans that have a well-defined weakness based on objective evidence and be characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful (Grade 8) – This loan grade is in accordance with regulatory guidance and includes loans that have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

Loss (Grade 9) – This loan grade is in accordance with regulatory guidance and includes loans that are considered uncollectible, or of such value that continuance as an asset is not warranted.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay the loan as agreed, the Company's loan rating process includes several layers of internal and external oversight. The Company's loan officers are responsible for the timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under the supervision of management. All commercial and agricultural loans are reviewed annually to ensure the appropriateness of the loan grade. In addition, the Company engages an external consultant on at least an annual basis to 1) review a minimum of 55% of the dollar volume of the commercial loan portfolio on an annual basis, 2) review new loans originated for over \$1.0 million in the last year, 3) review a majority of borrowers with commitments greater than or equal to \$1.0 million, 4) review selected loan relationships over \$750,000 which are over 30 days past due or classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate.

The following tables represent credit exposures by internally assigned grades as of March 31, 2017 and December 31, 2016 (in thousands):

March 31, 2017	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	\$240,229	\$14,732	\$12,136	\$-	\$-	\$267,097
Agricultural	143,715	7,835	4,749	-	-	156,299
Construction	26,118	-	-	-	-	26,118
Other commercial loans	53,657	1,560	4,498	85	-	59,800
Other agricultural loans	21,218	1,300	1,709	-	-	24,227
State and political subdivision loans	83,548	13,095	798	-	-	97,441
Total	\$568,485	\$38,522	\$23,890	\$85	\$-	\$630,982

December 31, 2016	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	\$225,185	\$14,045	\$13,347	\$-	\$-	\$252,577
Agricultural	110,785	8,231	4,608	-	-	123,624
Construction	25,441	-	-	-	-	25,441
Other commercial loans	51,396	2,049	5,105	89	-	58,639
Other agricultural loans	20,178	1,733	1,477	-	-	23,388
State and political subdivision loans						
	83,620	13,066	828	-	-	97,514
Total	\$516,605	\$39,124	\$25,365	\$89	\$-	\$581,183

For residential real estate mortgages, home equity and consumer loans, credit quality is monitored based on whether the loan is performing or non-performing, which is typically based on the aging status of the loan and payment activity, unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. Non-performing loans include those loans that are considered nonaccrual, described in more detail below, and all loans past due 90 or more days and still accruing. The following table presents the recorded investment in those loan classes based on payment activity as of March 31, 2017 and December 31, 2016 (in thousands):

March 31, 2017	Performing	Non-performing	PCI	Total
Real estate loans:				
Mortgages	\$145,446	\$1,539	\$35	\$147,020
Home Equity	56,566	231	-	56,797
Consumer	10,395	112	1	10,508
Total	\$212,407	\$1,882	\$36	\$214,325

December 31, 2016	Performing	Non-performing	PCI	Total
Real estate loans:				
Mortgages	\$147,047	\$1,648	\$35	\$148,730
Home Equity	58,438	255	-	\$58,693
Consumer	10,892	109	4	\$11,005
Total	\$216,377	\$2,012	\$39	\$218,428

#### Aging Analysis of Past Due Financing Receivables

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table includes an aging analysis of the recorded investment of past due financing receivables as of March 31, 2017 and December 31, 2016 (in thousands):



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	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	PCI	Total Financing Receivables	90 Days or Greater and Accruing
March 31, 2017								
Real estate loans:								
Mortgages	\$315	\$49	\$988	\$1,352	\$145,633	\$35	\$147,020	\$230
Home Equity	156	85	188	429	56,368	-	56,797	146
Commercial	301	645	3,973	4,919	260,213	1,965	267,097	58
Agricultural	22	-	1,338	1,360	154,202	737	156,299	334
Construction	-	-	-	-	26,118	-	26,118	-
Consumer	90	35	110	235	10,272	1	10,508	22
Other commercial loans	161	2	2,597	2,760	56,177	863	59,800	-
Other agricultural loans	774	-	225	999	23,228	-	24,227	225
State and political subdivision loans	-	-	-	-	97,441	-	97,441	-
Total	\$1,819	\$816	\$9,419	\$12,054	\$829,652	\$3,601	\$845,307	\$1,015
Loans considered non-accrual	\$77	\$10	\$8,404	\$8,491	\$1,991	\$-	\$10,482	
Loans still accruing	1,742	806	1,015	3,563	827,661	3,601	834,825	
Total	\$1,819	\$816	\$9,419	\$12,054	\$829,652	\$3,601	\$845,307	
December 31, 2016								
Real estate loans:								
Mortgages	\$630	\$36	\$1,109	\$1,775	\$146,920	\$35	\$148,730	\$173
Home Equity	384	49	209	642	58,051	-	58,693	160
Commercial	1,757	58	4,302	6,117	244,491	1,969	252,577	-
Agricultural	-	-	1,145	1,145	121,741	738	123,624	-
Construction	-	-	-	-	25,441	-	25,441	-
Consumer	115	40	83	238	10,763	4	11,005	67
Other commercial loans	95	35	4,004	4,134	53,884	621	58,639	-
Other agricultural loans	43	34	5	82	23,306	-	23,388	5
State and political subdivision loans	-	-	-	-	97,514	-	97,514	-
Total	\$3,024	\$252	\$10,857	\$14,133	\$782,111	\$3,367	\$799,611	\$405
Loans considered non-accrual	\$172	\$105	\$10,452	\$10,729	\$725	\$-	\$11,454	
Loans still accruing	2,852	147	405	3,404	781,386	3,367	788,157	
Total	\$3,024	\$252	\$10,857	\$14,133	\$782,111	\$3,367	\$799,611	

Nonaccrual Loans

Loans are considered for non-accrual status upon reaching 90 days delinquency, although the Company may be receiving partial payments of interest and partial repayments of principal on such loans or if full payment of principal and interest is not expected. Additionally, if management is made aware of other information including bankruptcy, repossession, death, or legal proceedings, the loan may be placed on non-accrual status. If a loan is 90 days or more past due and is well secured and in the process of collection, it may still be considered accruing.

The following table reflects the financing receivables, excluding PCI loans, on non-accrual status as of March 31, 2017 and December 31, 2016, respectively. The balances are presented by class of financing receivable (in thousands):

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	March 31, 2017	December 31, 2016
Real estate loans:		
Mortgages	\$1,309	\$ 1,475
Home Equity	85	95
Commercial	4,448	4,445
Agricultural	1,322	1,340
Consumer	90	42
Other commercial loans	3,228	4,057
	\$10,482	\$ 11,454

### Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a Troubled Debt Restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to structure more affordable terms before their loan reaches nonaccrual status. These restructured terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of interest or principal, or both, management measures any impairment on the restructuring by calculating the present value of the revised loan terms and comparing this balance to the Company's investment in the loan prior to the restructuring. As these loans are individually evaluated, they are excluded from pooled portfolios when calculating the allowance for loan and lease losses and a separate allocation within the allowance for loan and lease losses is provided. Management continually evaluates loans that are considered TDRs, including payment history under the modified loan terms, the borrower's ability to continue to repay the loan based on continued evaluation of their operating results and cash flows from operations. Based on this evaluation management would no longer consider a loan to be a TDR when the relevant facts support such a conclusion. As of March 31, 2017 and December 31, 2016, included within the allowance for loan losses are reserves of \$27,000 and \$29,000 respectively, that are associated with loans modified as TDRs.

Loan modifications that are considered TDRs completed during the three months ended March 31, 2017 were as follows (dollars in thousands):

		For the Three Months Ended March 31, 2017			
		Pre-modification		Post-Modification	
		Outstanding		Outstanding	
Number of		Recorded		Recorded	
contracts		Investment		Investment	
Interest		Interest Term		Interest Term	
Modification		Modification		Modification	
Real estate loans:					
Commercial	- 2	\$ -	\$ 703	\$ -	\$ 703
Total	- 2	\$ -	\$ 703	\$ -	\$ 703

There were no loan modifications that were considered TDRs during the three months ended March 31, 2016.

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. There were no loans that were modified as

TDRs during each 12-month period prior to the current reporting periods, which began January 1, 2017 and 2016 (three month periods) that subsequently defaulted during these reporting periods.

Allowance for Loan Losses

The following table segregates the allowance for loan losses (ALLL) into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of March 31, 2017 and December 31, 2016, respectively (in thousands):

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	March 31, 2017			December 31, 2016		
	Individually evaluated for impairment	Collectively evaluated for impairment	Total	Individually evaluated for impairment	Collectively evaluated for impairment	Total
Real estate loans:						
Residential	\$38	\$ 1,004	\$1,042	\$32	\$ 1,032	\$1,064
Commercial	47	3,618	3,665	45	3,544	3,589
Agricultural	103	1,849	1,952	54	1,440	1,494
Construction	-	46	46	-	47	47
Consumer	2	121	123	-	122	122
Other commercial loans	195	1,020	1,215	326	1,001	1,327
Other agricultural loans	19	287	306	30	282	312
State and political subdivision loans	-	824	824	-	833	833
Unallocated	-	232	232	-	98	98
Total	\$404	\$ 9,001	\$9,405	\$487	\$ 8,399	\$8,886

The following tables roll forward the balance of the ALLL by portfolio segment for the three month periods ended March 31, 2017 and 2016, respectively (in thousands):

	For the three months ended March 31, 2017				Balance at March 31, 2017
	Balance at December 31, 2016	Charge-offs	Recoveries	Provision	
Real estate loans:					
Residential	\$1,064	\$ (45 )	\$ -	\$ 23	\$1,042
Commercial	3,589	(41 )	4	113	3,665
Agricultural	1,494	-	-	458	1,952
Construction	47	-	-	(1 )	46
Consumer	122	(28 )	10	19	123
Other commercial loans	1,327	-	9	(121 )	1,215
Other agricultural loans	312	(5 )	-	(1 )	306
State and political subdivision loans	833	-	-	(9 )	824
Unallocated	98	-	-	134	232
Total	\$8,886	\$ (119 )	\$ 23	\$ 615	\$9,405

	For the three months ended March 31, 2016				Balance at March 31, 2016
	Balance at December 31, 2015	Charge-offs	Recoveries	Provision	
Real estate loans:					
Residential	\$905	\$ -	\$ -	\$ 61	\$966
Commercial	3,376	-	4	153	3,533
Agricultural	409	-	-	(4 )	405

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Construction	24	-	-	(10	)	14	
Consumer	102	(15	)	39	(30	)	96
Other commercial loans	1,183	-	6	33		1,222	
Other agricultural loans	122			3		125	
State and political subdivision loans	593	-	-	73		666	
Unallocated	392	-	-	(144	)	248	
Total	\$7,106	\$ (15	)	\$ 49	\$ 135	\$7,275	

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The Company allocates the ALLL based on the factors described below, which conform to the Company's loan classification policy and credit quality measurements. In reviewing risk within the Company's loan portfolio, management has determined there to be several different risk categories within the loan portfolio. The ALLL consists of amounts applicable to: (i) residential real estate loans; (ii) residential real estate home equity loans; (iii) commercial real estate loans; (iv) agricultural real estate loans; (v) real estate construction loans; (vi) other commercial and agricultural loans; (vii) consumer loans; (viii) other agricultural loans and (ix) state and political subdivision loans. Factors considered in this process include general loan terms, collateral, and availability of historical data to support the analysis. Historical loss percentages are calculated and used as the basis for calculating allowance allocations. Certain qualitative factors are evaluated to determine additional inherent risks in the loan portfolio, which are not necessarily reflected in the historical loss percentages. These factors are then added to the historical allocation percentage to get the adjusted factor to be applied to non-classified loans. The following qualitative factors are analyzed:

- Level of and trends in delinquencies and impaired/classified loans
- § Change in volume and severity of past due loans
- § Volume of non-accrual loans
- § Volume and severity of classified, adversely or graded loans;
- Level of and trends in charge-offs and recoveries;
- Trends in volume, terms and nature of the loan portfolio;
- Effects of any changes in risk selection and underwriting standards and any other changes in lending and recovery policies, procedures and practices;
- Changes in the quality of the Company's loan review system;
- Experience, ability and depth of lending management and other relevant staff;
- National, state, regional and local economic trends and business conditions
- § General economic conditions
- § Unemployment rates
- § Inflation rate/ Consumer Price Index
- § Changes in values of underlying collateral for collateral-dependent loans;
- Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses;
- Existence and effect of any credit concentrations, and changes in the level of such concentrations; and
- Any change in the level of board oversight.

The Company analyzes its loan portfolio each quarter to determine the adequacy of its ALLL.

Loans determined to be TDRs are impaired and for purposes of estimating the ALLL must be individually evaluated for impairment. In calculating the impairment, the Company calculates the present value utilizing an analysis of discounted cash flows. If the present value calculated is below the recorded investment of the loan, impairment is recognized by a charge to the provision for loan and lease losses and a credit to the ALLL.

We continually review the model utilized in calculating the required ALLL. The following are explanations for significant changes in the allowance by portfolio segment during the first three months of 2017:

Residential - There was an increase in the historical loss factor for residential loans when comparing March 31, 2017 to December 31, 2016. The specific reserve for residential loans increased slightly from December 31, 2016 to March 31, 2017. The qualitative factor level of and trend in charge-offs was increased for residential loans due the increase in charged off loans in the quarter. The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were decreased for residential loans due to the decrease in past due, non-accrual and classified loans. The qualitative factor for national, state, regional and local economic trends and business conditions were decreased for residential loan categories due to a decrease in the unemployment rates in the local economy during 2017.

Commercial real estate– There was an increase in the historical loss factor for commercial real estate loans when comparing March 31, 2017 to December 31, 2016. The specific reserve for commercial real estate loans increased slightly from December 31, 2016 to March 31, 2017. The qualitative factor for national, state, regional and local economic trends and business conditions was decreased for all commercial real estate loans due to a decrease in the unemployment rates in the local economy during 2017. The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were decreased for commercial real estate loans due to the decrease in past due and classified loans.

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Agricultural real estate – There was no change in the historical loss factor for agricultural real estate loans from December 31, 2016 to March 31, 2017. The specific reserve for agricultural real estate loans increased from December 31, 2016 to March 31, 2017. The qualitative factor for industry conditions, including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses, was decreased for agricultural real estate due to the improvement in the ratio of the price received for product sold versus feed costs that has occurred in 2017. The qualitative factor for national, state, regional and local economic trends and business conditions was decreased for agricultural real estate loans due to a decrease in the unemployment rates in the local economy during 2017.

Other commercial - There was a decrease in the historical loss factor for other commercial loans when comparing December 31, 2016 to March 31, 2017. The specific reserve for other commercial loans decreased from December 31, 2016 to March 31, 2017. The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans was decreased due to the decrease in past due loans. The qualitative factor for national, state, regional and local economic trends and business conditions was decreased for other commercial loans due to a decrease in the unemployment rates in the local economy during 2017.

The following are explanations for changes in the allowance by portfolio segment during the first three months of 2016:

Residential - There was an increase in the historical loss factor for residential loans when comparing December 31, 2015 to March 31, 2016. The specific reserve for residential loans increase between December 31, 2015 and March 31, 2016. The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were increased for residential loans due to an increase in past due, non-accrual and classified loans.

Commercial real estate– There was an increase in the historical loss factor for commercial real estate loans comparing December 31, 2015 to March 31, 2016. The specific reserve for commercial real estate loans increased between December 31, 2015 and March 31, 2016. The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were increased for commercial real estate loans due to an increase in past due, non-accrual and classified loans.

Agricultural real estate – There were no changes in the historical loss factor or specific reserves for agricultural real estate loans from December 31, 2015 to March 31, 2016. The qualitative factor for industry conditions, including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses, was increased for agricultural real estate due to the decrease in the price received for product sold and the increase in feed costs that occurred in 2016, which negatively affected customer earnings.

Other commercial - There was a decrease in the historical loss factor for other commercial loans when comparing December 31, 2015 to March 31, 2016. The specific reserve for other commercial loans increased from December 31, 2015 to December 31, 2016. There were no qualitative factor changes in the first quarter of 2016 for other commercial loans.

Other agricultural - There were no changes in the historical loss factor or specific reserves for other agricultural loans from December 31, 2015 to March 31, 2016. The qualitative factor for industry conditions, including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses, was increased for other agricultural loans due to the decrease in the price received for product sold and the increase in feed costs that occurred in 2016, which negatively affected customer earnings.

Municipal loans - There was no changes in the historical loss factor or specific reserve for municipal loans from December 31, 2015 to March 31, 2016. There were no qualitative factor changes in the first quarter of 2016 for other commercial loans.

## Foreclosed Assets Held For Sale

Foreclosed assets acquired in settlement of loans are carried at fair value, less estimated costs to sell, and are included in other assets on the Consolidated Balance Sheet. As of March 31, 2017 and December 31, 2016, included with other assets are \$1,248,000 and \$1,036,000, respectively, of foreclosed assets. As of March 31, 2017, included within the foreclosed assets are \$265,000 of consumer residential mortgages that were foreclosed on or received via a deed in lieu transaction prior to the period end. As of March 31, 2017, the Company has initiated formal foreclosure proceedings on \$1,422,000 of consumer residential mortgages, which have not yet been transferred into foreclosed assets.

## Note 6 – Goodwill and Other Intangible Assets

The following table provides the gross carrying value and accumulated amortization of intangible assets as of March 31, 2017 and December 31, 2016 (in thousands):

	March 31, 2017			December 31, 2016		
	Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
Amortized intangible assets (1):						
MSRs	\$1,509	\$ (833)	\$ 676	\$1,471	\$ (787)	\$ 684
Core deposit intangibles	1,641	(388)	1,253	1,641	(320)	1,321
Covenant not to compete	125	(42)	83	125	(34)	91
Total amortized intangible assets	\$3,275	\$ (1,262)	\$ 2,012	\$3,237	\$ (1,141)	\$ 2,096
Unamortized intangible assets:						
Goodwill	\$21,089			\$21,089		

(1) Excludes fully amortized intangible assets

The following table provides the current year and estimated future amortization expense for amortized intangible assets. We based our projections of amortization expense shown below on existing asset balances at March 31, 2017. Future amortization expense may vary from these projections (in thousands):

	MSRs	Core deposit intangibles	Covenant not to compete	Total
Three months ended March 31, 2017 (actual)	\$ 47	\$ 68	\$ 8	\$ 123
Three months ended March 31, 2016 (actual)	\$ 46	\$ 74	\$ 8	\$ 128
Estimate for year ended December 31,				
Remaining 2017	138	198	23	360
2018	150	236	30	416
2019	119	206	30	355
2020	91	177	-	268
2021	68	147	-	215

## Note 7 – Federal Home Loan Bank Stock

The Bank is a member of the FHLB of Pittsburgh and, as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. As of March 31, 2017 and December 31, 2016, the Bank's investment in FHLB stock was \$3,213,600 and \$4,542,000, respectively. The stock does not have a readily determinable fair value and, as such, is classified as restricted stock, carried at cost and evaluated by management for impairment. The stock's value is determined by the ultimate recoverability of the par value rather

than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) a significant decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB's regulatory capital ratios are sufficient, liquidity appears adequate, new shares of FHLB stock continue to exchange hands at the \$100 par value and the FHLB has repurchased shares of excess capital stock from its members and has paid a quarterly cash dividend.

## Note 8 – Repurchase Agreements

We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor collateral levels on a continuous basis. We may be required to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agents.

The value of the collateral segmented by the remaining contractual maturity of the repurchase agreements in the Consolidated Balance Sheets as of March 31, 2017 and December 31, 2016 is presented in the following tables (in thousands):

	Remaining Contractual Maturity of the Agreements				Total
	Overnight and	Up to 30 - 90 Days	Greater than 90 days		
March 31, 2017					
Repurchase Agreements:					
U.S. agency securities	\$16,157	\$ -	\$ -	\$2,060	\$18,217
Total carrying value of collateral pledged	\$16,157	\$ -	\$ -	\$2,060	\$18,217
Total liability recognized for repurchase agreements					\$15,962

	Remaining Contractual Maturity of the Agreements				Total
	Overnight and	Up to 30 - 90 Days	Greater than 90 days		
December 31, 2016					
Repurchase Agreements:					
U.S. agency securities	\$16,118	\$ -	\$ -	\$2,059	\$18,177
Total carrying value of collateral pledged	\$16,118	\$ -	\$ -	\$2,059	\$18,177
Total liability recognized for repurchase agreements					\$14,307

## Note 9 - Employee Benefit Plans

For additional detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 11 of the Company's Consolidated Financial Statements included in the 2016 Annual Report on Form 10-K.

## Noncontributory Defined Benefit Pension Plan

The Bank sponsors a trustee noncontributory defined benefit pension plan ("Pension Plan") covering substantially all employees and officers hired prior to January 1, 2007. Additionally, the Bank assumed the noncontributory defined benefit pension plan of FNB when it was acquired. The FNB plan was frozen prior to the acquisition and therefore, no additional benefits will accrue for employees covered under that plan. These two plans are collectively referred to herein as "the Plans." The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plans' actuary. Any employee with a hire date of January 1, 2007 or later is not eligible to

participate in the Pension Plan.

In lieu of the Pension Plan, employees with a hire date of January 1, 2007 or later are eligible to receive, after meeting certain length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

For employees who are eligible to participate in the Pension Plan, the Pension Plan requires benefits to be paid to eligible employees based primarily upon age and compensation rates during employment. Upon retirement or other termination of employment, employees can elect either an annuity benefit or a lump sum distribution of vested benefits in the Pension Plan.

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The following sets forth the components of net periodic benefit costs of the Pension Plan for the three months ended March 31, 2017 and 2016, respectively (in thousands):

	Three Months Ended March 31,	
	2017	2016
Service cost	\$91	\$90
Interest cost	167	172
Expected return on plan assets	(274)	(260)
Net amortization and deferral	60	61
Net periodic benefit cost	\$44	\$63

The Bank expects to contribute \$520,000 to the Pension Plans in 2017.

#### Defined Contribution Plan

The Company sponsors a voluntary 401(k) savings plan which eligible employees can elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). Under the plan, the Company also makes required contributions on behalf of the eligible employees. For the three months ended March 31, 2017 and 2016, contributions by the Company totaled \$99,000 and \$83,000, respectively.

#### Directors' Deferred Compensation Plan

The Company's directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. At March 31, 2017 and December 31, 2016, an obligation of \$907,000 and \$940,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Amounts included in interest expense on the deferred amounts totaled \$5,000 and \$4,000 for each of the three months ended March 31, 2017 and 2016, respectively.

#### Restricted Stock Plan

The Company maintains a Restricted Stock Plan (the "Plan") whereby employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company's common stock and are subject to certain vesting requirements including continuous employment or service with the Company. In April of 2016, the Company's shareholders authorized a total of 150,000 shares of the Company's common stock to be made available under the Plan. As of March 31, 2017, 145,740 shares remain available to be issued under the Plan. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

The following table details the vesting, awarding and forfeiting of restricted shares during the three month period ended March 31, 2017:

	Unvested	Weighted Average Market Price
	Shares	
Outstanding, beginning of period	8,471	\$ 49.10

Granted	150	51.13
Vested	(162 )	(51.24 )
Outstanding, end of period	8,459	\$ 49.10

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Compensation cost related to restricted stock is recognized, based on the market price of the stock at the grant date, over the vesting period. Compensation expense related to restricted stock was \$50,000 and \$47,000 for the three months ended March 31, 2017 and 2016, respectively. At March 31, 2017, the total compensation cost related to nonvested awards that has not yet been recognized was \$415,000, which is expected to be recognized over the next three years.

#### Supplemental Executive Retirement Plan

The Company maintains a non-qualified supplemental executive retirement plan ("SERP") for certain executives to compensate those executive participants in the Company's noncontributory defined benefit pension plan whose benefits are limited by compensation limitations under current tax law. At March 31, 2017 and December 31, 2016, an obligation of \$1,488,000 and \$1,460,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Expenses related to this plan totaled \$28,000 and \$30,000 for the three months ended March 31, 2017 and 2016, respectively.

#### Salary Continuation Plan

The Company maintains a salary continuation plan for certain employees retained through the acquisition of FNB or that were formerly employed by FNB. At March 31, 2017 and December 31, 2016, an obligation of \$720,000 was included in other liabilities for this plan in the Consolidated Balance Sheet. Expenses related to this plan totaled \$13,000 and \$16,000 for the three months ended March 31, 2017 and 2016, respectively.

#### Continuation of Life Insurance Plan

The Company, as part of the acquisition of FNB, has promised a continuation of certain split-dollar life insurance policies that provide coverage to certain persons post-retirement. U.S. generally accepted accounting principles require the recording of post-retirement costs and a liability equal to the present value of the cost of post-retirement insurance during the person's term of service. The estimated present value of future benefits to be paid totaled \$571,000 and \$569,000 as of March 31, 2017 and December 31, 2016, respectively, which is included in other liabilities in the Consolidated Balance Sheet.

#### Note 9 – Accumulated Comprehensive Income

The following tables present the changes in accumulated other comprehensive income by component net of tax for the three months ended March 31, 2017 and 2016 (in thousands):

	Three months ended March 31, 2017		
	Unrealized gain (loss) on available Defined for sale Pension securities		
	(a)	(a)	Total
Balance as of December 31, 2016	\$1,306	\$(2,698 )	\$(1,392)
Other comprehensive income (loss) before reclassifications (net of tax)	46	-	46
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	(114 )	39	(75 )



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Net current period other comprehensive income (loss)	(68 )	39	(29 )
Balance as of March 31, 2017	\$1,238	\$(2,659 )	\$(1,421)
	Three months ended March 31, 2016		
	Unrealized gain (loss) on available Defined for Benefit Pension securities Items		
	(a)	(a)	Total
Balance as of December 31, 2015	\$2,204	\$(2,440 )	\$(236 )
Other comprehensive income (loss) before reclassifications (net of tax)	1,117	-	1,117
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	(18 )	40	22
Net current period other comprehensive income (loss)	1,099	40	1,139
Balance as of March 31, 2016	\$3,303	\$(2,400 )	\$903

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The following table presents the significant amounts reclassified out of each component of accumulated other comprehensive income for the three months ended March 31, 2017 and 2016 (in thousands):

Details about accumulated other comprehensive income (loss)	Amount reclassified from accumulated comprehensive income (loss)		Affected line item in the Consolidated Statement of Income
	Three Months Ended March 31, 2017	2016	
Unrealized gains and losses on available for sale securities	\$ 172	\$ 27	Investment securities gains, net
	(58 )	(9 )	Provision for income taxes
	\$ 114	\$ 18	Net of tax
Defined benefit pension items	\$ (60 )	\$ (60 )	Salaries and employee benefits
	21	20	Provision for income taxes
	\$ (39 )	\$ (40 )	Net of tax
Total reclassifications	\$ 75	\$ (22 )	

Note 10 – Fair Value Measurements

The Company has established a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by this hierarchy are as follows:

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

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

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

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

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, the Company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. Our valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or

reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and/or quarterly valuation process.

## Financial Instruments Recorded at Fair Value on a Recurring Basis

The fair values of securities available for sale are determined by quoted prices in active markets, when available, and classified as Level I. If quoted market prices are not available, the fair value is determined by a matrix pricing, which is a mathematical technique, widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities and classified as Level II. The fair values consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

The following tables present the assets and liabilities reported on the Consolidated Balance Sheet at their fair value on a recurring basis as of March 31, 2017 and December 31, 2016 by level within the fair value hierarchy (in thousands). Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

March 31, 2017	Level I	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Assets				
Securities available for sale:				
U.S. Agency securities	\$-	\$ 147,658	\$ -	\$ 147,658
Obligations of state and political subdivisions	-	88,243	-	88,243
Corporate obligations	-	3,095	-	3,095
Mortgage-backed securities in government sponsored entities	-	41,118	-	41,118
Equity securities in financial institutions	1,659	-	-	1,659

December 31, 2016	Level I	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Securities available for sale:				
U.S. Agency securities	\$-	\$ 170,414	\$ -	\$ 170,414
U.S. Treasuries securities	3,000	-	-	3,000
Obligations of state and political subdivisions	-	96,926	-	96,926
Corporate obligations	-	3,050	-	3,050
Mortgage-backed securities in government sponsored entities	-	37,728	-	37,728
Equity securities in financial institutions	2,899	-	-	2,899

## Financial Instruments, Non-Financial Assets and Non-Financial Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain financial assets, financial liabilities, non-financial assets and non-financial liabilities at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market value that were recognized at fair value below cost at the end of the period. Certain non-financial assets measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. Non-financial assets measured at fair value on a non-recurring basis during 2017 and 2016 include certain foreclosed

assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for possible loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense.

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Assets measured at fair value on a nonrecurring basis as of March 31, 2017 and December 31, 2016 are included in the table below (in thousands):

	Level I	Level II	Level III	Total
March 31, 2017				
Impaired Loans	\$ -	\$ -	\$ 2,064	\$ 2,064
Other real estate owned	-	-	1,074	1,074

December 31, 2016

Impaired Loans	\$ -	\$ -	\$ 2,033	\$ 2,033
Other real estate owned	-	-	839	839

Impaired Loans - The Company has measured impairment on impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral dependent loan is less than the carrying amount of the loan a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the table above as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is not included in the table above as it is not currently being carried at its fair value. The fair values above excluded estimated selling costs of \$185,000 and \$188,000 at March 31, 2017 and December 31, 2016, respectively.

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

The following table provides a listing of the significant unobservable inputs used in the fair value measurement process for items valued utilizing Level III techniques (dollars in thousands).

Quantitative Information about Level III Fair Value Measurements

	Fair Value	Valuation Technique(s)	Unobservable input	Range	Weighted average
March 31, 2017					
Impaired Loans	\$2,064	Appraised Collateral Values	Discount for time since appraisal	0-90 %	28.73 %
			Selling costs	5%-10 %	7.55 %
			Holding period	6 - 12 months	12 months
Other real estate owned	1,074	Appraised Collateral Values	Discount for time since appraisal	12-47 %	21.51 %
December 31, 2016					
Impaired Loans	2,033	Appraised Collateral Values	Discount for time since appraisal	0-65 %	28.98 %
			Selling costs	5%-9 %	7.56 %

Holding period	6 - 12 months	11 months
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Other real estate owned	839	Appraised Collateral Values	Discount for time since appraisal	10-67 %	25.45 %
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The fair values of the Company's financial instruments are as follows (in thousands):

	Carrying Amount	Fair Value	Level I	Level II	Level III
March 31, 2017					
Financial assets:					
Cash and due from banks	\$14,797	\$14,797	\$14,797	\$-	\$-
Interest bearing time deposits with other banks	6,708	6,712	-	-	6,712
Available-for-sale securities	281,773	281,773	1,659	280,114	
Loans held for sale	1,581	1,581	1,581		
Net loans	835,902	838,299	-	-	838,299
Bank owned life insurance	26,389	26,389	26,389	-	-
Regulatory stock	3,977	3,977	3,977	-	-
Accrued interest receivable	3,618	3,618	3,618	-	-
Financial liabilities:					
Deposits	\$1,037,609	\$1,036,063	\$775,628	\$-	\$260,435
Borrowed funds	46,836	45,104	6,849	-	38,255
Accrued interest payable	612	612	612	-	-
December 31, 2016					
Financial assets:					
Cash and due from banks	\$17,754	\$17,754	\$17,754	\$-	\$-
Interest bearing time deposits with other banks	6,955	6,960	-	-	6,960
Available-for-sale securities	314,017	314,017	5,899	308,118	-
Loans held for sale	1,827	1,827	1,827		
Net loans	790,725	797,184	-	-	797,184
Bank owned life insurance	26,223	26,223	26,223	-	-
Regulatory stock	5,306	5,306	5,306	-	-
Accrued interest receivable	4,089	4,089	4,089	-	-
Financial liabilities:					
Deposits	\$1,005,503	\$1,004,072	\$740,889	\$-	\$263,183
Borrowed funds	79,662	77,425	41,330	-	36,095
Accrued interest payable	720	720	720	-	-

Fair value is determined based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the estimates.

Fair values have been determined by the Company using historical data, as generally provided in the Company's regulatory reports, and an estimation methodology suitable for each category of financial instruments. The Company's fair value estimates, methods and assumptions are set forth below for the Company's other financial instruments.

Cash and Cash Equivalents:

The carrying amounts for cash and cash equivalents approximate fair value because they have original maturities of 90 days or less and do not present unanticipated credit concerns.



Accrued Interest Receivable and Payable:

The carrying amounts for accrued interest receivable and payable approximate fair value because they are generally received or paid in 90 days or less and do not present unanticipated credit concerns.

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Interest bearing time deposits with other banks:

The fair value of interest bearing time deposits with other banks is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Available-For-Sale Securities:

The fair values of securities available for sale are determined by quoted prices in active markets, when available, and classified as Level I. If quoted market prices are not available, the fair value is determined by a matrix pricing, which is a mathematical technique, widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities and classified as Level II. The fair values consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Loans held-for-sale:

The carrying amount for loans held for sale approximates fair value as the loans are only held for less than a week from origination.

Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans has been estimated by discounting expected future cash flows. The discount rate used in these calculations is derived from the Treasury yield curve adjusted for credit quality, operating expense and prepayment option price, and is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified as required by an estimate of the effect of current economic and lending conditions.

Bank Owned Life Insurance:

The carrying value of bank owned life insurance approximates fair value based on applicable redemption provisions.

Regulatory Stock:

The carrying value of regulatory stock approximates fair value based on applicable redemption provisions.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings and NOW accounts, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

The deposits' fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

Borrowed Funds:

Rates available to the Company for borrowed funds with similar terms and remaining maturities are used to estimate the fair value of borrowed funds.

## Note 11 – Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this Update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Because the guidance does not apply to revenue associated with financial instruments, including loans and securities, we do not expect the new standard, or any of the amendments, to result in a material change from our current accounting for revenue because the majority of the Company's financial instruments are not within the scope of Topic 606. However, we do expect that the standard will result in new disclosure requirements, which are currently being evaluated.

In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606). The amendments in this Update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. The Company is evaluating the effect of adopting this new accounting Update.

In September 2015, the FASB issued ASU 2015-16, Business Combinations (Topic 805). The amendments in this Update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this Update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this Update require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. This Update is not expected to have a significant impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) 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; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred

tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after

December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact to the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1% increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606). The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services (that are an output of the entity's ordinary activities) in exchange for consideration. The amendments in this Update do not change the core principle of the guidance in Topic 606; they simply clarify the implementation guidance on principal versus agent considerations. The amendments in this Update are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements of Update 2014-09. ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718). The amendments in this Update affect all entities that issue share-based payment awards to their employees. The standards in this Update provide simplification for several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as with equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. In addition to those simplifications, the amendments eliminate the guidance in Topic 718 that was indefinitely deferred shortly after the issuance of FASB Statement No. 123 (revised 2004), Share-Based Payment. This should not result in a change in practice because the guidance that is being superseded was never effective. For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for any entity in any interim or annual period. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606). The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services in exchange for consideration. The amendments in this Update do not change the core principle for revenue recognition in Topic 606. Instead, the amendments provide (1) more detailed guidance in a few areas and (2) additional implementation guidance and examples based on feedback the FASB received from its stakeholders. The amendments are expected to reduce the degree of judgment necessary to comply with Topic 606, which the FASB expects will reduce the potential for diversity arising in practice and reduce the cost and complexity of applying the guidance. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

In May 2016, the FASB issued ASU 2016-12, Revenue from Contracts with Customers (Topic 606), which among other things clarifies the objective of the collectability criterion in Topic 606, as well as certain narrow aspects of Topic 606. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements for Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. This Update is not expected to have a significant impact on the Company's consolidated financial statements

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

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which addresses eight specific cash flow issues with the objective of reducing diversity in practice. Among these include recognizing cash payments for debt prepayment or debt extinguishment as cash outflows for financing activities; cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage; and cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash inflows from investing activities while the cash payments for premiums on bank-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal

years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. The Company is currently evaluating the impact the adoption of the standard will have on the Company's statement of cash flows.



In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740), which requires recognition of current and deferred income taxes resulting from an intra-entity transfer of any asset (excluding inventory) when the transfer occurs. Consequently, the amendments in this Update eliminate the exception for an intra-entity transfer of an asset other than inventory. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those annual reporting periods. For all other entities, the amendments are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements. The amendments in this Update should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

In October 2016, the FASB issued ASU 2016-17, Consolidation (Topic 810), which amends the consolidation guidance on how a reporting entity that is the single decision maker of a VIE should treat indirect interests in the entity held through related parties that are under common control with the reporting entity when determining whether it is the primary beneficiary of that VIE. The primary beneficiary of a VIE is the reporting entity that has a controlling financial interest in a VIE and, therefore, consolidates the VIE. A reporting entity has an indirect interest in a VIE if it has a direct interest in a related party that, in turn, has a direct interest in the VIE. Under the amendments, a single decision maker is not required to consider indirect interests held through related parties that are under common control with the single decision maker to be the equivalent of direct interests in their entirety. Instead, a single decision maker is required to include those interests on a proportionate basis consistent with indirect interests held through other related parties. This Update is not expected to have a significant impact on the Company's consolidated financial statements.

In October 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230), which requires that a statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. 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 amendments in this Update should be applied using a retrospective transition method to each period presented. The Company is currently evaluating the impact the adoption of the standard will have on the Company's statement of cash flows.

In December 2016, the FASB issued ASU 2016-19, Technical Corrections and Improvements, which represents changes to clarify, correct errors, or make minor improvements to the Accounting Standards Codification. The amendments make the Accounting Standards Codification easier to understand and easier to apply by eliminating inconsistencies and providing clarifications. Most of the amendments in this Update do not require transition guidance and are effective upon issuance of this Update. This Update is not expected to have a significant impact on the Company's financial statements.

In December 2016, the FASB issued ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers. This Update, among others things, clarifies that guarantee fees within the scope of Topic 460, Guarantees, (other than product or service warranties) are not within the scope of Topic 606. The effective date and transition requirements for ASU 2016-20 are the same as the effective date and transition requirements for the new revenue recognition guidance. For public entities with a calendar year-end, the new guidance is effective in the quarter and year beginning January 1, 2018. For all other entities with a calendar year-end, the new guidance is effective in the year ending December 31, 2019, and interim periods in 2020. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

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

In January 2017, the FASB issued ASU 2017-03, Accounting Changes and Error Corrections (Topic 250) and Investments—Equity Method and Joint Ventures (Topic 323), Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings. This Update adds an SEC paragraph to the Codification following an SEC Staff Announcement about applying Staff Accounting Bulletin (SAB) Topic 11.M. Specifically, this announcement applies to ASU 2014-09, Revenue from Contracts with Customers (Topic 606); ASU 2016-02, Leases (Topic 842); and ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. A registrant should evaluate Updates that have not yet been adopted to determine the appropriate financial statement disclosures about the potential material effects of those Updates on the financial statements when adopted. If a registrant does not know or cannot reasonably estimate the impact that adoption of the Updates referenced in this announcement are expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed. The amendments in this Update are effective immediately.

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

business entity that is not an SEC filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities that are adopting the amendments in this Update should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.

In February 2017, the FASB issued ASU 2017-05, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20). The amendments in this Update clarify what constitutes a financial asset within the scope of Subtopic 610-20. The amendments also clarify that entities should identify each distinct nonfinancial asset or in substance nonfinancial asset that is promised to a counterparty and to derecognize each asset when the counterparty obtains control. There is also additional guidance provided for partial sales of a nonfinancial asset and when derecognition, and the related gain or loss, should be recognized. The amendments in this Update are effective at the same time as the amendments in Update 2014-09. Therefore, for public entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. For all other entities, the amendments in this Update are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

In February 2017, the FASB issued ASU 2017-06, Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965). This Update relates primarily to the reporting by an employee benefit plan for its interest in a master trust, which is a trust for which a regulated financial institution serves as a trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held. For each master trust in which a plan holds an interest, the amendments in this Update require a plan's interest in that master trust and any change in that interest to be presented in separate line items in the statement of net assets available for benefits and in the statement of changes in net assets available for benefits, respectively. The amendments in this Update remove the requirement to disclose the percentage interest in the master trust for plans with divided interests and require that all plans disclose the dollar amount of their interest in each of those general types of investments, which supplements the existing requirement to disclose the master trusts balances in each general type of investments. There are also increased disclosure requirements for investments in master trusts. The amendments in this Update are effective for fiscal years beginning after December 15, 2018. Early adoption is permitted.

In March 2017, the FASB issued ASU 2017-07, Compensation—Retirement Benefits (Topic 715). The amendments in this Update require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost as defined in paragraphs 715-30-35-4 and 715-60-35-9 are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are used to present the other components of net benefit cost, that line item or items must be appropriately described. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed.

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20). The amendments in this Update shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or expected future results of operations of Citizens Financial Services, Inc., First Citizens Community Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use words such as "believes," "expects," "anticipates," or similar expressions, we are making forward-looking statements. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements. The Company cautions readers that the following important factors, among others, could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement:

- Interest rates could change more rapidly or more significantly than we expect.  
The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
- The financial markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.  
It could take us longer than we anticipate to implement strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.
- We may not be able to successfully integrate businesses we acquire or be able to fully realize the expected financial and other benefits from acquisitions.
- Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.  
We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition or operating results.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices or requirements.  
We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition. We could also experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.  
The agricultural economy is subject to extreme swings in both the costs of resources and the prices received from the sale of products, which could negatively impact our customers.
- A budget impasse in the Commonwealth of Pennsylvania could impact our asset values, liquidity and profitability.  
Companies providing support services related to the exploration and drilling of the natural gas reserves in our market area may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection, which could negatively impact our customers and, as a result, negatively impact our loan and deposit volume and loan quality. Additionally, the activities the companies providing support services related to the exploration and drilling of the natural gas reserves may be dependent on the market price of natural gas. As a result, decreases in the market price of natural gas could also negatively impact these companies, our customers.

Additional factors that may affect our results are discussed under "Part II – Item 1A – Risk Factors" in this report and in the Company's 2016 Annual Report on Form 10-K under "Item 1.A/ Risk Factors." Except as required by applicable law and regulation, we assume no obligation to update or revise any forward-looking statements after the date on which they are made.

## Introduction

The following is management's discussion and analysis of the financial condition and results of operations at the dates and for the periods presented in the accompanying consolidated financial statements for the Company. Our consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three months ended March 31, 2017 are not necessarily indicative of the results you may expect for the full year.

The Company currently engages in the general business of banking throughout our service area of Potter, Tioga, Clinton and Bradford counties in north central Pennsylvania, Union county in central Pennsylvania, Lebanon, Lancaster, Berks and Schuylkill counties in south central Pennsylvania and Allegany county in southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 27 banking facilities, 26 of which operate as bank branches. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Mansfield Wal-Mart Super Center, Mill Hall, Schuylkill Haven, Friedensburg, Mt. Aetna, Fredericksburg, Mount Joy and three branches near the city of Lebanon, Pennsylvania. In New York, our office is in Wellsville. We have a limited branch office in Winfield, Pennsylvania, which primarily serves agricultural customers in the central Pennsylvania market.

## Risk Management

Risk identification and management are essential elements for the successful management of the Company. In the normal course of business, the Company is subject to various types of risk, including interest rate, credit, liquidity, reputational and regulatory risk.

Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the direction and frequency of changes in interest rates. Interest rate risk results from various re-pricing frequencies and the maturity structure of the financial instruments owned by the Company. The Company uses its asset/liability and funds management policy to control and manage interest rate risk.

Credit risk represents the possibility that a customer may not perform in accordance with contractual terms. Credit risk results from loans with customers and the purchasing of securities. The Company's primary credit risk is in the loan portfolio. The Company manages credit risk by adhering to an established credit policy and through a disciplined evaluation of the adequacy of the allowance for loan losses. Also, the investment policy limits the amount of credit risk that may be taken in the investment portfolio.

Liquidity risk represents the inability to generate or otherwise obtain funds at reasonable rates to satisfy commitments to borrowers and obligations to depositors. The Company has established guidelines within its asset/liability and funds management policy to manage liquidity risk. These guidelines include, among other things, contingent funding alternatives.

Reputational risk, or the risk to our business, earnings, liquidity, and capital from negative public opinion, could result from our actual or alleged conduct in a variety of areas, including legal and regulatory compliance, lending practices, corporate governance, litigation, ethical issues, or inadequate protection of customer information. We expend significant resources to comply with regulatory requirements. Failure to comply could result in reputational harm or significant legal or remedial costs. Damage to our reputation could adversely affect our ability to retain and attract new customers, and adversely impact our earnings and liquidity.

Regulatory risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company. We cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.



## Competition

The banking industry in the Bank's service areas continue to be extremely competitive, both among commercial banks and with financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions, agricultural cooperatives and internet entities. Competition in our north central Pennsylvania market has increased as a result of other financial institutions looking to expand into new markets. With larger population centers in our central and south central markets, we experience more competition to gather deposits and to make loans than in our north central Pennsylvania market. Mortgage banking firms, financial companies, financial affiliates of industrial companies, brokerage firms, retirement fund management firms and even government agencies provide additional competition for loans and other financial services. The Bank is generally competitive with all competing financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

## Trust and Investment Services; Oil and Gas Services

Our Investment and Trust Services Division offers professional trust administration, investment management services, estate planning and administration, and custody of securities. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the Consolidated Financial Statements since such items are not assets of the Company. Revenues and fees of the Trust Department are reflected in trust income in the Consolidated Statement of Income. As of March 31, 2017 and December 31, 2016, the Trust Department had \$114.6 million and \$110.6 million of assets under management, respectively.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc. The assets associated with these products are not included in the Consolidated Financial Statements since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from \$137.4 million at December 31, 2016 to \$142.8 million at March 31, 2017. Fee income from the sale of these products is reflected in brokerage and insurance income in the Consolidated Statement of Income. Management believes that there are opportunities to increase non-interest income through these products and services, especially in our central and south central Pennsylvania markets.

In addition to traditional trust and investment services offered, we assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. As of March 31, 2017, customers owning 6,961 acres have signed agreements with the Bank that provide for the Bank to manage oil and gas matters related to the customers land, which may include negotiating lease payments and royalty percentages, resolving leasing issues, accounting for and ensuring the accuracy of royalty checks, distributing revenue to satisfy investment objectives and providing customized reports outlining payment and distribution information.

## Results of Operations

### Overview of the Income Statement

The Company had net income of \$3,303,000 for the first three months of 2017 compared to \$3,283,000 for last year's comparable period, an increase of \$20,000. Basic earnings per share for the first three months of 2017 were \$1.00, compared to \$0.98 last year, representing a 2.0% increase. Annualized return on assets and return on equity for the three months of 2017 were 1.08% and 10.45%, respectively, compared with 1.11% and 10.81% for last year's comparable period.

### Net Interest Income



Net interest income, the most significant component of the Company's earnings, is the amount by which interest income generated from interest-earning assets exceeds interest expense on interest-bearing liabilities.

Net interest income for the first three months of 2017 was \$9,997,000, an increase of \$792,000, or 8.6%, compared to the same period in 2016. For the first three months of 2017, the provision for loan losses totaled \$615,000, an increase of \$480,000 over the comparable period in 2016. Consequently, net interest income after the provision for loan losses was \$9,382,000 compared to \$9,070,000 during the first three months of 2016.

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The following table sets forth the average balances of, and the interest earned or incurred on, for each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and interest rate spread created for the three months ended March 31, 2017 and 2016 on a tax equivalent basis (dollars in thousands):

(dollars in thousands)	Analysis of Average Balances and Interest Rates (1)					
	Three Months Ended					
	March 31, 2017			March 31, 2016		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
\$		\$ %	\$		\$ %	
<b>ASSETS</b>						
<b>Short-term investments:</b>						
Interest-bearing deposits at banks	7,643	2	0.11	33,660	35	0.42
Total short-term investments	7,643	2	0.11	33,660	35	0.42
Interest bearing time deposits at banks	6,870	33	1.97	7,697	36	1.87
<b>Investment securities:</b>						
Taxable	210,364	879	1.67	261,076	1,024	1.57
Tax-exempt (3)	90,783	1,013	4.46	100,103	1,169	4.67
Total investment securities	301,147	1,892	2.51	361,179	2,193	2.43
<b>Loans:</b>						
Residential mortgage loans	205,978	2,634	5.19	202,535	2,672	5.31
Construction	28,150	304	4.38	13,295	165	4.99
Commercial & farm loans	485,338	5,879	4.91	365,257	4,761	5.24
Loans to state & political subdivisions	97,178	1,012	4.22	106,067	1,143	4.34
Other loans	10,495	209	8.06	11,231	229	8.19
Loans, net of discount (2)(3)(4)	827,139	10,038	4.92	698,385	8,970	5.17
Total interest-earning assets	1,142,799	11,965	4.25	1,100,921	11,234	4.10
Cash and due from banks	6,671			7,174		
Bank premises and equipment	17,007			17,292		
Other assets	56,145			56,961		
Total non-interest earning assets	79,823					