

PENNS WOODS BANCORP INC  
Form 10-Q  
May 10, 2016  
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
for the Quarterly Period Ended March 31, 2016.

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.

No. 0-17077  
(Commission File Number)

PENNS WOODS BANCORP, INC.  
(Exact name of Registrant as specified in its charter)  
PENNSYLVANIA 23-2226454  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

300 Market Street, P.O. Box 967 Williamsport, Pennsylvania 17703-0967  
(Address of principal executive offices) (Zip Code)

(570) 322-1111  
Registrant's telephone number, including area code

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x

Non-accelerated filer  Small reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

On May 1, 2016 there were 4,733,252 shares of the Registrant's common stock outstanding.

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

PENNS WOODS BANCORP, INC.  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

|   | March 31,<br>2016  | December<br>31,<br>2015 |
|---|--------------------|-------------------------|
| (In Thousands, Except Share Data)   |                    |                         |
| <b>ASSETS:</b>  |                    |                         |
| Noninterest-bearing balances  | \$22,371           | \$22,044                |
| Interest-bearing balances in other financial institutions   | 24,754             | 752                     |
| Total cash and cash equivalents   | 47,125             | 22,796                  |
| Investment securities, available for sale, at fair value  | 153,709            | 176,157                 |
| Investment securities, trading  | 60                 | 73                      |
| Loans held for sale   | 514                | 757                     |
| Loans   | 1,041,252          | 1,045,207               |
| Allowance for loan losses   | (12,382)           | (12,044)                |
| Loans, net  | 1,028,870          | 1,033,163               |
| Premises and equipment, net   | 22,158             | 21,830                  |
| Accrued interest receivable   | 3,878              | 3,686                   |
| Bank-owned life insurance   | 26,867             | 26,667                  |
| Investment in limited partnerships  | 746                | 899                     |
| Goodwill  | 17,104             | 17,104                  |
| Intangibles   | 2,078              | 1,240                   |
| Deferred tax asset  | 8,426              | 8,990                   |
| Other assets  | 6,602              | 6,695                   |
| <b>TOTAL ASSETS</b>   | <b>\$1,318,137</b> | <b>\$1,320,057</b>      |
| <b>LIABILITIES:</b>   |                    |                         |
| Interest-bearing deposits   | \$790,219          | \$751,797               |
| Noninterest-bearing deposits  | 269,362            | 280,083                 |
| Total deposits  | 1,059,581          | 1,031,880               |
| Short-term borrowings   | 15,874             | 46,638                  |
| Long-term borrowings  | 91,025             | 91,025                  |
| Accrued interest payable  | 439                | 426                     |
| Other liabilities   | 13,555             | 13,809                  |
| <b>TOTAL LIABILITIES</b>  | <b>1,180,474</b>   | <b>1,183,778</b>        |
| <b>SHAREHOLDERS' EQUITY:</b>  |                    |                         |
| Preferred stock, no par value, 3,000,000 shares authorized; no shares issued                        | —                  | —                       |
| Common stock, par value \$8.33, 15,000,000 shares authorized; 5,005,534 and 5,004,984 shares issued | 41,713             | 41,708                  |
| Additional paid-in capital  | 50,004             | 49,992                  |
| Retained earnings   | 58,888             | 58,038                  |
| Accumulated other comprehensive loss:   |                    |                         |
| Net unrealized gain on available for sale securities  | 1,324              | 258                     |

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|  |             |   |             |   |
|--|-------------|---|-------------|---|
| Defined benefit plan                               | (4,032      | ) | (4,057      | ) |
| Treasury stock at cost, 272,452 and 257,852 shares | (10,234     | ) | (9,660      | ) |
| TOTAL SHAREHOLDERS' EQUITY                         | 137,663     |   | 136,279     |   |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY         | \$1,318,137 |   | \$1,320,057 |   |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF INCOME  
(UNAUDITED)

|   | Three Months<br>Ended March 31, |           |
|---|---------------------------------|-----------|
| (In Thousands, Except Per Share Data)                   | 2016                            | 2015      |
| INTEREST AND DIVIDEND INCOME:                           |                                 |           |
| Loans, including fees                                   | \$10,355                        | \$ 9,323  |
| Investment securities:                                  |                                 |           |
| Taxable   | 622                             | 1,014     |
| Tax-exempt  | 475                             | 767       |
| Dividend and other interest income                      | 274                             | 293       |
| TOTAL INTEREST AND DIVIDEND INCOME                      | 11,726                          | 11,397    |
| INTEREST EXPENSE:                                       |                                 |           |
| Deposits  | 834                             | 743       |
| Short-term borrowings                                   | 26                              | 19        |
| Long-term borrowings                                    | 492                             | 524       |
| TOTAL INTEREST EXPENSE                                  | 1,352                           | 1,286     |
| NET INTEREST INCOME                                     | 10,374                          | 10,111    |
| PROVISION FOR LOAN LOSSES                               | 350                             | 700       |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES     | 10,024                          | 9,411     |
| NON-INTEREST INCOME:                                    |                                 |           |
| Service charges   | 532                             | 553       |
| Net securities gains, available for sale                | 435                             | 661       |
| Net securities gains, trading                           | 40                              | —         |
| Bank-owned life insurance                               | 184                             | 188       |
| Gain on sale of loans                                   | 467                             | 299       |
| Insurance commissions                                   | 206                             | 234       |
| Brokerage commissions                                   | 255                             | 245       |
| Other   | 878                             | 1,080     |
| TOTAL NON-INTEREST INCOME                               | 2,997                           | 3,260     |
| NON-INTEREST EXPENSE:                                   |                                 |           |
| Salaries and employee benefits                          | 4,580                           | 4,470     |
| Occupancy   | 541                             | 628       |
| Furniture and equipment                                 | 701                             | 595       |
| Pennsylvania shares tax                                 | 258                             | 224       |
| Amortization of investment in limited partnerships      | 152                             | 165       |
| Federal Deposit Insurance Corporation deposit insurance | 232                             | 215       |
| Marketing   | 210                             | 129       |
| Intangible amortization                                 | 87                              | 82        |
| Other   | 2,300                           | 1,960     |
| TOTAL NON-INTEREST EXPENSE                              | 9,061                           | 8,468     |
| INCOME BEFORE INCOME TAX PROVISION                      | 3,960                           | 4,203     |
| INCOME TAX PROVISION                                    | 882                             | 848       |
| NET INCOME  | \$3,078                         | \$ 3,355  |
| EARNINGS PER SHARE - BASIC AND DILUTED                  | \$0.65                          | \$ 0.70   |
| WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC AND DILUTED | 4,740,503                       | 4,801,505 |
| DIVIDENDS DECLARED PER SHARE                            | \$0.47                          | \$ 0.47   |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME  
 (UNAUDITED)

| (In Thousands)   | Three Months    |         |
|--|-----------------|---------|
|  | Ended March 31, |         |
|  | 2016            | 2015    |
| Net Income   | \$3,078         | \$3,355 |
| Other comprehensive income:                                    |                 |         |
| Change in unrealized gain on available for sale securities     | 2,050           | 1,208   |
| Tax effect   | (697 )          | (411 )  |
| Net realized gain included in net income                       | (435 )          | (661 )  |
| Tax effect   | 148             | 225     |
| Amortization of unrecognized pension and post-retirement items | 39              | —       |
| Tax effect   | (14 )           | —       |
| Total other comprehensive income                               | 1,091           | 361     |
| Comprehensive income   | \$4,169         | \$3,716 |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
(UNAUDITED)

|   | COMMON<br>STOCK |          | ADDITIONAL<br>PAID-IN<br>CAPITAL | RETAINED<br>EARNINGS | ACCUMULATED<br>OTHER<br>COMPREHENSIVE<br>LOSS | TREASURY<br>STOCK | TOTAL<br>SHAREHOLDERS'<br>EQUITY |
|---|-----------------|----------|----------------------------------|----------------------|---|-------------------|----------------------------------|
| (In Thousands, Except Per Share Data)                 | SHARES          | AMOUNT   |                                  |                      |   |                   |                                  |
| Balance, December 31, 2014                            | 5,002,649       | \$41,688 | \$49,896                         | \$53,107             | \$(1,667 )                                    | \$(7,057 )        | \$135,967                        |
| Net income  |                 |          |                                  | 3,355                |   |                   | 3,355                            |
| Other comprehensive income                            |                 |          |                                  |                      | 361   |                   | 361                              |
| Dividends declared, (\$0.47 per share)                |                 |          |                                  | (2,257 )             |   |                   | (2,257 )                         |
| Common shares issued for employee stock purchase plan | 520             | 5        | 18                               |                      |   |                   | 23                               |
| Purchase of treasury stock (9,610 shares)             |                 |          |                                  |                      |   | (445 )            | (445 )                           |
| Balance, March 31, 2015                               | 5,003,169       | \$41,693 | \$49,914                         | \$54,205             | \$(1,306 )                                    | \$(7,502 )        | \$137,004                        |

|   | COMMON<br>STOCK |          | ADDITIONAL<br>PAID-IN<br>CAPITAL | RETAINED<br>EARNINGS | ACCUMULATED<br>OTHER<br>COMPREHENSIVE<br>LOSS | TREASURY<br>STOCK | TOTAL<br>SHAREHOLDERS'<br>EQUITY |
|---|-----------------|----------|----------------------------------|----------------------|---|-------------------|----------------------------------|
| (In Thousands, Except Per Share Data)                 | SHARES          | AMOUNT   |                                  |                      |   |                   |                                  |
| Balance, December 31, 2015                            | 5,004,984       | \$41,708 | \$49,992                         | \$58,038             | \$(3,799 )                                    | \$(9,660 )        | \$136,279                        |
| Net income  |                 |          |                                  | 3,078                |   |                   | 3,078                            |
| Other comprehensive loss                              |                 |          |                                  |                      | 1,091   |                   | 1,091                            |
| Dividends declared, (\$0.47 per share)                |                 |          |                                  | (2,228 )             |   |                   | (2,228 )                         |
| Common shares issued for employee stock purchase plan | 550             | 5        | 12                               |                      |   |                   | 17                               |
| Purchase of treasury stock (14,600 shares)            |                 |          |                                  |                      |   | (574 )            | (574 )                           |
| Balance, March 31, 2016                               | 5,005,534       | \$41,713 | \$50,004                         | \$58,888             | \$(2,708 )                                    | \$(10,234 )       | \$137,663                        |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

| (In Thousands)  | Three Months<br>Ended March 31, |                 |
|---|---------------------------------|-----------------|
|   | 2016                            | 2015            |
| <b>OPERATING ACTIVITIES:</b>  |                                 |                 |
| Net Income  | \$3,078                         | \$3,355         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |                 |
| Depreciation and amortization   | 863                             | 826             |
| Amortization of intangible assets   | 87                              | 82              |
| Provision for loan losses   | 350                             | 700             |
| Accretion and amortization of investment security discounts and premiums          | 228                             | 208             |
| Net securities gains, available for sale  | (435 )                          | (661 )          |
| Originations of loans held for sale   | (12,617 )                       | (9,424 )        |
| Proceeds of loans held for sale   | 13,327                          | 9,210           |
| Gain on sale of loans   | (467 )                          | (299 )          |
| Net securities gains, trading   | (40 )                           | —               |
| Proceeds from the sale of trading securities                                      | 2,930                           | —               |
| Purchases of trading securities   | (2,877 )                        | —               |
| Earnings on bank-owned life insurance   | (184 )                          | (188 )          |
| Decrease in deferred tax asset  | 15                              | 114             |
| Other, net  | (1,516 )                        | (2,193 )        |
| Net cash provided by operating activities   | 2,742                           | 1,730           |
| <b>INVESTING ACTIVITIES:</b>  |                                 |                 |
| Proceeds from sales of available for sale securities                              | 19,839                          | 15,807          |
| Proceeds from calls and maturities of available for sale securities               | 6,535                           | 5,204           |
| Purchases of available for sale securities  | (3,270 )                        | (9,217 )        |
| Net decrease (increase) in loans  | 3,918                           | (28,751 )       |
| Acquisition of premises and equipment   | (732 )                          | (128 )          |
| Proceeds from the sale of foreclosed assets                                       | 6                               | 476             |
| Purchase of bank-owned life insurance   | (27 )                           | (27 )           |
| Proceeds from redemption of regulatory stock                                      | 2,155                           | 2,265           |
| Purchases of regulatory stock   | (989 )                          | (2,693 )        |
| Net cash provided by (used for) investing activities                              | 27,435                          | (17,064 )       |
| <b>FINANCING ACTIVITIES:</b>  |                                 |                 |
| Net increase in interest-bearing deposits   | 38,422                          | 12,217          |
| Net decrease (increase) in noninterest-bearing deposits                           | (10,721 )                       | 2,853           |
| Proceeds from long-term borrowings  | —                               | 15,000          |
| Net decrease in short-term borrowings   | (30,764 )                       | (10,193 )       |
| Dividends paid  | (2,228 )                        | (2,257 )        |
| Issuance of common stock  | 17                              | 23              |
| Purchases of treasury stock   | (574 )                          | (445 )          |
| Net cash (used for) provided by provided by financing activities                  | (5,848 )                        | 17,198          |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>24,329</b>                   | <b>1,864</b>    |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING</b>                                       | <b>22,796</b>                   | <b>19,908</b>   |
| <b>CASH AND CASH EQUIVALENTS, ENDING</b>  | <b>\$47,125</b>                 | <b>\$21,772</b> |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                         |                                 |                 |

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|   |         |         |
|---|---------|---------|
| Interest paid                               | \$1,339 | \$1,228 |
| Income taxes paid                           | 950     | 800     |
| Transfer of loans to foreclosed real estate | 25      | 7       |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

## Note 1. Basis of Presentation

The consolidated financial statements include the accounts of Penns Woods Bancorp, Inc. (the “Company”) and its wholly-owned subsidiaries: Woods Investment Company, Inc., Woods Real Estate Development Company, Inc., Luzerne Bank, and Jersey Shore State Bank (Jersey Shore State Bank and Luzerne Bank are referred to together as the “Banks”) and Jersey Shore State Bank’s wholly-owned subsidiary, The M Group, Inc. D/B/A The Comprehensive Financial Group (“The M Group”). All significant inter-company balances and transactions have been eliminated in the consolidation.

The interim financial statements are unaudited, but in the opinion of management reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 40 through 48 of the Form 10-K for the year ended December 31, 2015.

In reference to the attached financial statements, all adjustments are of a normal recurring nature pursuant to Rule 10-01(b) (8) of Regulation S-X.

## Note 2. Accumulated Other Comprehensive Loss

The changes in accumulated other comprehensive loss by component as of March 31, 2016 and 2015 were as follows:

| (In Thousands)   | Three Months Ended March 31, 2016                    |                      |           | Three Months Ended March 31, 2015                    |                      |           |
|--|--|----------------------|-----------|--|----------------------|-----------|
|  | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total     | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total     |
| Beginning balance  | \$258  | \$(4,057)            | \$(3,799) | \$2,930  | \$(4,597)            | \$(1,667) |
| Other comprehensive income before reclassifications            | 1,353  | —                    | 1,353     | 797  | —                    | 797       |
| Amounts reclassified from accumulated other comprehensive loss | (287 )   | 25                   | (262 )    | (436 )   | —                    | (436 )    |
| Net current-period other comprehensive income                  | 1,066  | 25                   | 1,091     | 361  | —                    | 361       |
| Ending balance   | \$1,324  | \$(4,032)            | \$(2,708) | \$3,291  | \$(4,597)            | \$(1,306) |

The reclassifications out of accumulated other comprehensive loss as of March 31, 2016 and 2015 were as follows:

| Details about Accumulated Other Comprehensive Loss Components | Amount Reclassified from Accumulated Other Comprehensive Loss |                              |   |
|---|---|------------------------------|---|
|   | Three Months Ended March 31,                                  | Three Months Ended March 31, | in the Consolidated Statement of Income |

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|  | 2016   |   | 2015   |  |
|--|--------|---|--------|--|
| Net unrealized gain on available for sale securities | \$ 435 |   | \$ 661 | Net securities gains, available for sale |
| Income tax effect                                    | (148   | ) | (225   | ) Income tax provision                   |
| Total reclassifications for the period               | \$ 287 |   | \$ 436 | Net of tax                               |
| <br>   |        |   |        |  |
| Net unrecognized pension costs                       | \$ (39 | ) | \$ —   | Salaries and employee benefits           |
| Income tax effect                                    | 14     |   | —      | Income tax provision                     |
| Total reclassifications for the period               | \$ (25 | ) | \$ —   | Net of tax                               |

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Note 3. Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The updates 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. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operation.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40). The amendments in this update provide guidance in accounting principles generally accepted in the United States of America about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The amendments in this update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. This update is not expected to have a significant impact on the Company's financial statements.

In May 2015, the FASB issued ASU 2015-08, Business Combinations - Pushdown Accounting - Amendment to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115. This ASU was issued to amend various SEC paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115. This update is not expected to have a significant impact on the Company's financial statements.

In August 2015, the FASB issued ASU 2015-14, Revenue from Contract 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. The Company is evaluating the effect of adopting this new accounting update.

In August 2015, the FASB issued ASU 2015-15, Interest-Imputation of Interest (Subtopic 835-30) Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting. This ASU adds SEC paragraphs pursuant to the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting about the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. This update is not expected to have a significant impact on the Company's financial statements.

In November 2015, the FASB issued ASU 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes.

The amendments in this update require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments in this update apply to all entities that present a classified statement of financial position. For public business entities, the amendments in this update are effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments in this update are effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Earlier application is permitted for all entities as of the beginning of an interim or annual reporting period. The amendments in this update may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. This update is not expected to have a significant impact on the Company's 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 an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for



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financial instruments; (g) 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 (h) 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 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 evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In March 2016, the FASB issued ASU 2016-04, Liabilities - Extinguishments of Liabilities (Subtopic 405-20). The standard provides that liabilities related to the sale of prepaid stored-value products within the scope of this Update are financial liabilities. The amendments in the Update provide a narrow scope exception to the guidance in Subtopic 405-20 to require that breakage for those liabilities be accounted for consistent with the breakage guidance in Topic 606. The amendments in this update are effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Earlier application is permitted, including adoption in an interim period. This update is not expected to have a significant impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-05, Derivatives and Hedging (Topic 815). The amendments in this update apply to all reporting entities for which there is a change in the counterparty to a derivative instrument that has been designated as a hedging instrument under Topic 815. The standards in this update clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require designation of that hedging relationship provided that all other hedge accounting criteria continue to be met. For public business entities, the amendments in this update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments in this update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. An entity has an option to apply the amendments in this update on either a prospective basis or a modified retrospective basis. Early adoption is permitted, including adoption in an interim period. This update is not expected to have a

significant impact on the Company's financial statements.

Note 4. Per Share Data

There are no convertible securities which would affect the denominator in calculating basic and dilutive earnings per share. There are 32,500 stock options outstanding, however, since the strike price of \$42.03 is greater than the market price the options are not included in the denominator when calculating basic and dilutive earnings per share. Net income as presented on the consolidated statement of income will be used as the numerator. The following table sets forth the composition of the weighted average common shares (denominator) used in the basic and dilutive earnings per share computation.

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|  | Three Months Ended<br>March 31, |            |
|--|---------------------------------|------------|
|  | 2016                            | 2015       |
| Weighted average common shares issued  | 5,005,160                       | 5,002,832  |
| Average treasury stock shares  | (264,657 )                      | (201,327 ) |
| Weighted average common shares and common stock equivalents used to calculate basic and diluted earnings per share | 4,740,503                       | 4,801,505  |

## Note 5. Investment Securities

The amortized cost and fair values of investment securities available for sale at March 31, 2016 and December 31, 2015 are as follows:

| (In Thousands)                          | March 31, 2016    |                              |                               |               |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Available for sale (AFS)                |                   |                              |                               |               |
| U.S. Government and agency securities   | \$3,474           | \$ 4                         | \$ (2 )                       | \$3,476       |
| Mortgage-backed securities              | 9,465             | 337                          | (51 )                         | 9,751         |
| Asset-backed securities                 | 1,826             | —                            | (33 )                         | 1,793         |
| State and political securities          | 68,533            | 2,044                        | (2 )                          | 70,575        |
| Other debt securities                   | 57,080            | 452                          | (1,317 )                      | 56,215        |
| Total debt securities                   | 140,378           | 2,837                        | (1,405 )                      | 141,810       |
| Financial institution equity securities | 8,924             | 834                          | (23 )                         | 9,735         |
| Other equity securities                 | 2,401             | 15                           | (252 )                        | 2,164         |
| Total equity securities                 | 11,325            | 849                          | (275 )                        | 11,899        |
| Total investment securities AFS         | \$151,703         | \$ 3,686                     | \$ (1,680 )                   | \$153,709     |

| (In Thousands)                          | December 31, 2015 |                              |                               |               |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Available for sale (AFS)                |                   |                              |                               |               |
| U.S. Government and agency securities   | \$3,586           | \$ —                         | \$ (37 )                      | \$3,549       |
| Mortgage-backed securities              | 9,785             | 284                          | (60 )                         | 10,009        |
| Asset-backed securities                 | 1,960             | —                            | (20 )                         | 1,940         |
| State and political securities          | 84,992            | 1,797                        | (234 )                        | 86,555        |
| Other debt securities                   | 59,832            | 185                          | (2,245 )                      | 57,772        |
| Total debt securities                   | 160,155           | 2,266                        | (2,596 )                      | 159,825       |
| Financial institution equity securities | 10,397            | 1,100                        | (14 )                         | 11,483        |
| Other equity securities                 | 5,214             | 70                           | (435 )                        | 4,849         |
| Total equity securities                 | 15,611            | 1,170                        | (449 )                        | 16,332        |
| Total investment securities AFS         | \$175,766         | \$ 3,436                     | \$ (3,045 )                   | \$176,157     |

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The amortized cost and fair values of trading investment securities at March 31, 2016 and December 31, 2015 are as follows.

| (In Thousands)                          | March 31, 2016 |                        |                         |
|---|----------------|------------------------|-------------------------|
|   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses |
| Trading                                 |                |                        |                         |
| Financial institution equity securities | \$60           | \$—                    | —\$ 60                  |
| Total equity securities                 | 60             | —                      | 60                      |
| Total trading securities                | \$60           | \$—                    | —\$ 60                  |

| (In Thousands)                          | December 31, 2015 |                        |                         |
|---|-------------------|------------------------|-------------------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses |
| Trading                                 |                   |                        |                         |
| Financial institution equity securities | \$78              | \$—                    | (5 )                    |
| Total equity securities                 | 78                | —                      | (5 )                    |
| Total trading securities                | \$78              | \$—                    | (5 )                    |

Total net realized trading gains of \$40,000 for the three months ended March 31, 2016 were included in the Consolidated Statement of Income. There were no net realized trading gains for the corresponding period of 2015.

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at March 31, 2016 and December 31, 2015.

| (In Thousands)                          | March 31, 2016          |                         |                          |                         |            |                         |
|---|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
|   | Less than Twelve Months |                         | Twelve Months or Greater |                         | Total      |                         |
|   | Fair Value              | Gross Unrealized Losses | Fair Value               | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Available for sale (AFS)                |                         |                         |                          |                         |            |                         |
| U.S. Government and agency securities   | \$—                     | \$—                     | \$ 1,378                 | \$ (2 )                 | \$1,378    | \$(2 )                  |
| Mortgage-backed securities              | 667                     | (2 )                    | 3,723                    | (49 )                   | 4,390      | (51 )                   |
| Asset-backed securities                 | 1,533                   | (29 )                   | 260                      | (4 )                    | 1,793      | (33 )                   |
| State and political securities          | 1,396                   | (2 )                    | —                        | —                       | 1,396      | (2 )                    |
| Other debt securities                   | 7,419                   | (158 )                  | 22,030                   | (1,159 )                | 29,449     | (1,317 )                |
| Total debt securities                   | 11,015                  | (191 )                  | 27,391                   | (1,214 )                | 38,406     | (1,405 )                |
| Financial institution equity securities | 146                     | (4 )                    | 48                       | (19 )                   | 194        | (23 )                   |
| Other equity securities                 | 295                     | (113 )                  | 1,019                    | (139 )                  | 1,314      | (252 )                  |
| Total equity securities                 | 441                     | (117 )                  | 1,067                    | (158 )                  | 1,508      | (275 )                  |
| Total investment securities AFS         | \$11,456                | \$(308 )                | \$ 28,458                | \$(1,372 )              | \$39,914   | \$(1,680 )              |



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| (In Thousands)                          | December 31, 2015       |                         |                          |                         |            |                         |
|---|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
|   | Less than Twelve Months |                         | Twelve Months or Greater |                         | Total      |                         |
|   | Fair Value              | Gross Unrealized Losses | Fair Value               | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Available for sale (AFS)                |                         |                         |                          |                         |            |                         |
| U.S. Government and agency securities   | \$—                     | \$ —                    | \$ 3,549                 | \$ (37 )                | \$3,549    | \$ (37 )                |
| Mortgage-backed securities              | 6,081                   | (60 )                   | —                        | —                       | 6,081      | (60 )                   |
| Asset-backed securities                 | 1,626                   | (16 )                   | 314                      | (4 )                    | 1,940      | (20 )                   |
| State and political securities          | 7,345                   | (47 )                   | 1,656                    | (187 )                  | 9,001      | (234 )                  |
| Other debt securities                   | 24,381                  | (530 )                  | 22,547                   | (1,715 )                | 46,928     | (2,245 )                |
| Total debt securities                   | 39,433                  | (653 )                  | 28,066                   | (1,943 )                | 67,499     | (2,596 )                |
| Financial institution equity securities | —                       | —                       | 53                       | (14 )                   | 53         | (14 )                   |
| Other equity securities                 | 2,363                   | (277 )                  | 1,001                    | (158 )                  | 3,364      | (435 )                  |
| Total equity securities                 | 2,363                   | (277 )                  | 1,054                    | (172 )                  | 3,417      | (449 )                  |
| Total investment securities AFS         | \$41,796                | \$ (930 )               | \$ 29,120                | \$ (2,115 )             | \$70,916   | \$ (3,045 )             |

At March 31, 2016 there were a total of 13 securities in a continuous unrealized loss position for less than twelve months and 20 individual securities that were in a continuous unrealized loss position for twelve months or greater.

The Company reviews its position quarterly and has determined that, at March 31, 2016, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at March 31, 2016, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands)                    | Amortized Cost | Fair Value |
|-----------------------------------|----------------|------------|
| Due in one year or less           | \$ 1,806       | \$ 1,812   |
| Due after one year to five years  | 31,032         | 31,106     |
| Due after five years to ten years | 79,232         | 79,456     |
| Due after ten years               | 28,308         | 29,436     |
| Total                             | \$ 140,378     | \$ 141,810 |

Total gross proceeds from sales of securities available for sale were \$19,839,000 and \$15,807,000 for the three months ended March 31, 2016 and 2015, respectively.

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The following table represents gross realized gains and losses within the available for sale portfolio:

| (In Thousands)                          | Three<br>Months<br>Ended<br>March 31, |       |
|---|---------------------------------------|-------|
|   | 2016                                  | 2015  |
| Gross realized gains:                   |                                       |       |
| State and political securities          | 299                                   | 396   |
| Other debt securities                   | 32                                    | 74    |
| Financial institution equity securities | 82                                    | 155   |
| Other equity securities                 | 144                                   | 132   |
| Total gross realized gains              | \$557                                 | \$757 |
| Gross realized losses:                  |                                       |       |
| U.S. Government and agency securities   | \$—                                   | \$—   |
| State and political securities          | —                                     | 22    |
| Other debt securities                   | 81                                    | 32    |
| Other equity securities                 | 41                                    | 42    |
| Total gross realized losses             | \$122                                 | \$96  |

The following table represents gross realized gains and losses within the trading portfolios:

| (In Thousands)                          | Three<br>Months<br>Ended<br>March 31, |      |
|---|---------------------------------------|------|
|   | 2016                                  | 2015 |
| Gross realized gains:                   |                                       |      |
| Financial institution equity securities | \$ 6                                  | \$ — |
| Other equity securities                 | 59                                    | —    |
| Total gross realized gains              | \$ 65                                 | \$ — |
| Gross realized losses:                  |                                       |      |
| Financial institution equity securities | \$ 13                                 | \$ — |
| Other equity securities                 | 12                                    | —    |
| Total gross realized losses             | \$ 25                                 | \$ — |

There were no impairment charges included in gross realized losses for the three months ended March 31, 2016 and 2015, respectively.

Investment securities with a carrying value of approximately \$123,691,000 and \$131,089,000 at March 31, 2016 and December 31, 2015, respectively, were pledged to secure certain deposits, repurchase agreements, and for other purposes as required by law.

Note 6. Loans

Management segments the Banks' loan portfolio to a level that enables risk and performance monitoring according to similar risk characteristics. Loans are segmented based on the underlying collateral characteristics. Categories include commercial, financial, and agricultural, real estate, and installment loans to individuals. Real estate loans are further segmented into three categories: residential, commercial, and construction.



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The following table presents the related aging categories of loans, by segment, as of March 31, 2016 and December 31, 2015:

| (In Thousands)                          | March 31, 2016    |                              |   |                 |              |
|---|-------------------|------------------------------|---|-----------------|--------------|
|   | Current           | Past Due<br>30 To 89<br>Days | Past Due 90<br>Days Or More<br>& Still Accruing | Non-<br>Accrual | Total        |
| Commercial, financial, and agricultural | \$ 152,282        | \$ 317                       | \$ —  | \$ 292          | \$ 152,891   |
| Real estate mortgage:                   |                   |                              |   |                 |              |
| Residential                             | 523,897           | 5,761                        | 308   | 1,458           | 531,424      |
| Commercial                              | 296,145           | 802                          | —   | 9,312           | 306,259      |
| Construction                            | 25,111            | —                            | —   | 278             | 25,389       |
| Installment loans to individuals        | 26,290            | 412                          | —   | —               | 26,702       |
|   | 1,023,725         | \$ 7,292                     | \$ 308  | \$ 11,340       | 1,042,665    |
| Net deferred loan fees and discounts    | (1,413 )          |                              |   |                 | (1,413 )     |
| Allowance for loan losses               | (12,382 )         |                              |   |                 | (12,382 )    |
| Loans, net                              | \$ 1,009,930      |                              |   |                 | \$ 1,028,870 |
|   | December 31, 2015 |                              |   |                 |              |
| (In Thousands)                          | Current           | Past Due<br>30 To 89<br>Days | Past Due 90<br>Days Or More<br>& Still Accruing | Non-<br>Accrual | Total        |
| Commercial, financial, and agricultural | \$ 162,312        | \$ 164                       | \$ —  | \$ 1,596        | \$ 164,072   |
| Real estate mortgage:                   |                   |                              |   |                 |              |
| Residential                             | 517,753           | 6,827                        | 714   | 889             | 526,183      |
| Commercial                              | 295,784           | 720                          | 265   | 5,770           | 302,539      |
| Construction                            | 26,545            | 67                           | —   | 212             | 26,824       |
| Installment loans to individuals        | 26,572            | 429                          | —   | —               | 27,001       |
|   | 1,028,966         | \$ 8,207                     | \$ 979  | \$ 8,467        | 1,046,619    |
| Net deferred loan fees and discounts    | (1,412 )          |                              |   |                 | (1,412 )     |
| Allowance for loan losses               | (12,044 )         |                              |   |                 | (12,044 )    |
| Loans, net                              | \$ 1,015,510      |                              |   |                 | \$ 1,033,163 |

Purchased loans acquired are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses.

Upon the acquisition of Luzerne Bank on June 1, 2013, the Company evaluated whether each acquired loan (regardless of size) was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired 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. There were no material increases or decreases in the expected cash flows of these loans between June 1, 2013 (the “acquisition date”) and March 31, 2016. The fair value of purchased credit-impaired loans, on the acquisition date, was determined, primarily based on the fair value of loan collateral. The carrying value of purchased loans acquired with deteriorated credit quality was \$337,000 at March 31, 2016.

On the acquisition date, the preliminary estimate of the unpaid principal balance for all loans evidencing credit impairment acquired in the Luzerne Bank acquisition was \$1,211,000 and the estimated fair value of the loans was \$878,000. Total contractually required payments on these loans, including interest, at the acquisition date was

\$1,783,000. However, the Company's preliminary estimate of expected cash flows was \$941,000. At such date, the Company established a credit risk related non-accretable discount (a discount representing amounts which are not expected to be collected from either the customer or liquidation of collateral) of \$842,000 relating to these impaired loans, reflected in the recorded net fair value. Such amount is reflected as a non-accretable fair value adjustment to loans. The Company further estimated the timing and amount of expected cash flows in excess of the estimated fair value and established an accretable discount of \$63,000 on the acquisition date relating to these impaired loans.

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The following table presents additional information regarding loans acquired in the Luzerne Bank transaction with specific evidence of deterioration in credit quality:

| (In Thousands)      | March<br>31,<br>2016 | December 31,<br>2015 |
|---------------------|----------------------|----------------------|
| Outstanding balance | \$ 437               | \$ 441               |
| Carrying amount     | 337                  | 341                  |

There were no material increases or decreases in the expected cash flows of these loans between June 1, 2013 (the “acquisition date”) and March 31, 2016. There has been no allowance for loan losses recorded for acquired loans with specific evidence of deterioration in credit quality as of March 31, 2016.

The following table presents interest income the Banks would have recorded if interest had been recorded based on the original loan agreement terms and rate of interest for non-accrual loans and interest income recognized on a cash basis for non-accrual loans for the three months ended March 31, 2016 and 2015:

| (In Thousands)                          | Three Months Ended March 31,                                 |   |  |  |
|---|--|---|--|--|
|   | 2016   |   | 2015   |  |
|   | Interest<br>Would Have<br>Recorded<br>Original<br>Cash Basis | Interest That<br>Would Have<br>Recorded<br>Original<br>Term<br>Cash Basis | Interest<br>Would Have<br>Recorded<br>Original<br>Term<br>Cash Basis | Interest<br>Recorded<br>Original<br>Term<br>Cash Basis |
| Commercial, financial, and agricultural | \$ 4   | \$ 1  | \$ 12  | \$ 8   |
| Real estate mortgage:                   |  |   |  |  |
| Residential                             | 32   | 14  | 5  | 9  |
| Commercial                              | 169  | 64  | 105  | 25   |
| Construction                            | 6  | —   | 15   | 7  |
|   | \$ 211   | \$ 79   | \$ 137   | \$ 49  |

**Impaired Loans**

Impaired loans are loans for which it is probable the Banks will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Banks evaluate such loans for impairment individually and does not aggregate loans by major risk classifications. The definition of “impaired loans” is not the same as the definition of “non-accrual loans,” although the two categories overlap. The Banks may choose to place a loan on non-accrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loan. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$100,000 and if the loan is either on non-accrual status or has a risk rating of substandard. Management may also elect to measure an individual loan for impairment if less than \$100,000 on a case-by-case basis.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed. Interest income for impaired loans is recorded consistent with the Banks' policy on non-accrual loans.

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The following table presents the recorded investment, unpaid principal balance, and related allowance of impaired loans by segment as of March 31, 2016 and December 31, 2015:

| (In Thousands)                          | March 31, 2016      |                          |                   |
|---|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded:     |                     |                          |                   |
| Commercial, financial, and agricultural | \$304               | \$ 304                   | \$ —              |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,598               | 1,598                    | —                 |
| Commercial                              | 2,595               | 2,645                    | —                 |
| Construction                            | 279                 | 279                      | —                 |
|   | 4,776               | 4,826                    | —                 |
| With an allowance recorded:             |                     |                          |                   |
| Commercial, financial, and agricultural | 291                 | 291                      | 219               |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,533               | 1,646                    | 353               |
| Commercial                              | 10,601              | 10,601                   | 1,984             |
| Construction                            | —                   | —                        | —                 |
|   | 12,425              | 12,538                   | 2,556             |
| Total:                                  |                     |                          |                   |
| Commercial, financial, and agricultural | 595                 | 595                      | 219               |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 3,131               | 3,244                    | 353               |
| Commercial                              | 13,196              | 13,246                   | 1,984             |
| Construction                            | 279                 | 279                      | —                 |
|   | \$17,201            | \$ 17,364                | \$ 2,556          |

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| (In Thousands)                          | December 31, 2015   |                          |                   |
|---|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded:     |                     |                          |                   |
| Commercial, financial, and agricultural | \$ 319              | \$ 319                   | \$ —              |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,142               | 1,142                    | —                 |
| Commercial                              | 1,735               | 1,785                    | —                 |
| Construction                            | 212                 | 212                      | —                 |
|   | 3,408               | 3,458                    | —                 |
| With an allowance recorded:             |                     |                          |                   |
| Commercial, financial, and agricultural | 150                 | 150                      | 75                |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,573               | 1,703                    | 376               |
| Commercial                              | 10,752              | 10,752                   | 1,653             |
| Construction                            | —                   | —                        | —                 |
|   | 12,475              | 12,605                   | 2,104             |
| Total:                                  |                     |                          |                   |
| Commercial, financial, and agricultural | 469                 | 469                      | 75                |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 2,715               | 2,845                    | 376               |
| Commercial                              | 12,487              | 12,537                   | 1,653             |
| Construction                            | 212                 | 212                      | —                 |
|   | \$ 15,883           | \$ 16,063                | \$ 2,104          |

The following table presents the average recorded investment in impaired loans and related interest income recognized for the three months ended for March 31, 2016 and 2015:

| (In Thousands)                          | Three Months Ended March 31,         |  |  |                                      |  |  |
|---|--------------------------------------|--|--|--------------------------------------|--|--|
|   | 2016                                 |  |  | 2015                                 |  |  |
|   | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans |
| Commercial, financial, and agricultural | \$ 533                               | \$ 4   | \$ 1   | \$ 1,149                             | \$ 5   | \$ 7   |
| Real estate mortgage:                   |                                      |  |  |                                      |  |  |
| Residential                             | 2,899                                | 22   | 14   | 1,644                                | 12   | 5  |
| Commercial                              | 12,829                               | 82   | 63   | 14,773                               | 71   | 25   |
| Construction                            | 245                                  | —  | 1  | 719                                  | —  | 7  |
|   | \$ 16,506                            | \$ 108   | \$ 79  | \$ 18,285                            | \$ 88  | \$ 44  |

Currently, there is \$23,000 committed to be advanced in connection with impaired loans.

#### Troubled Debt Restructurings

The loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (“TDR”), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial

difficulties. These concessions typically result from loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

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There were no loan modifications that were considered TDRs completed during the three months ended March 31, 2016. Loan modifications that are considered TDRs completed during the three months ended March 31, 2015 and were as follows:

| (In Thousands, Except Number of Contracts) | 2015   |  |
|--|--|--|
|  | Pre-Modification<br>Number<br>of<br>Outstanding<br>Recorded<br>Contracts<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial, financial, and agricultural    | 2 \$ 97  | \$ 97  |
| Real estate mortgage:                      |  |  |
| Residential                                | 5 234  | 234  |
| Commercial                                 | 1 270  | 270  |
| Construction                               | —  | —  |
|  | 8 \$ 601   | \$ 601   |

Of the eight new troubled debt restructurings granted for the three months ended March 31, 2015, two loans totaling \$97,000 were granted term concessions and six loans totaling \$504,000 were granted concessions due to other default. All of the loans with modifications considered TDRs for the three months ended March 31, 2015 had a specific allowance within the allowance for loan losses.

There were five loan modifications considered to be TDRs made during the twelve months previous to March 31, 2016 that defaulted during the three months ended March 31, 2016. The defaulted loan types and recorded investments at March 31, 2016 are as follows: one commercial loan with a recorded investment of \$103,000, one commercial real estate loan with a recorded investment of \$239,000, and three residential real estate loan with a recorded investment of \$173,000. There was one loan modifications considered TDRs made during the twelve months previous to March 31, 2015 that defaulted during the three months ended March 31, 2015. The loan that defaulted is a commercial real estate loans with a recorded investment of \$48,000 at March 31, 2015.

Troubled debt restructurings amounted to \$9,503,000 and \$9,645,000 as of March 31, 2016 and December 31, 2015.

The amount of foreclosed residential real estate held at March 31, 2016 and December 31, 2015, totaled \$126,000 and \$102,000, respectively. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process at March 31, 2016 and December 31, 2015, totaled \$938,000 and \$448,000, respectively.

Internal Risk Ratings

Management uses a ten point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The special mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a substandard classification. Loans in the substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are evaluated for substandard classification. Loans in the doubtful category exhibit the same weaknesses found in the substandard loans, however, the weaknesses are more



pronounced. Such loans are static and collection in full is improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Loans classified loss are considered uncollectible and charge-off is imminent.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Banks have a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the pass category unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. An external annual loan review of large commercial relationships is performed, as well as a sample of smaller transactions. Confirmation of the appropriate risk category is included in the review. Detailed reviews, including plans for resolution, are performed on loans classified as substandard, doubtful, or loss on a quarterly basis.

The following table presents the credit quality categories identified above as of March 31, 2016 and December 31, 2015:

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|                 | March 31, 2016                   |             |                   |              |                |              |
|-----------------|----------------------------------|-------------|-------------------|--------------|----------------|--------------|
|                 | Commercial Real Estate Mortgages |             | Installment Loans |              |                |              |
| (In Thousands)  | Financial, and Agricultural      | Residential | Commercial        | Construction | to Individuals | Totals       |
| Pass            | \$ 151,347                       | \$ 527,868  | \$ 284,453        | \$ 25,111    | \$ 26,702      | \$ 1,015,481 |
| Special Mention | 1,238                            | 808         | 5,573             | —            | —              | 7,619        |
| Substandard     | 306                              | 2,748       | 16,233            | 278          | —              | 19,565       |
|                 | \$ 152,891                       | \$ 531,424  | \$ 306,259        | \$ 25,389    | \$ 26,702      | \$ 1,042,665 |

|                 | December 31, 2015                |             |                   |              |                |              |
|-----------------|----------------------------------|-------------|-------------------|--------------|----------------|--------------|
|                 | Commercial Real Estate Mortgages |             | Installment Loans |              |                |              |
| (In Thousands)  | Financial, and Agricultural      | Residential | Commercial        | Construction | to Individuals | Totals       |
| Pass            | \$ 160,734                       | \$ 522,853  | \$ 277,248        | \$ 26,612    | \$ 27,001      | \$ 1,014,448 |
| Special Mention | 1,669                            | 823         | 8,625             | —            | —              | 11,117       |
| Substandard     | 1,669                            | 2,507       | 16,666            | 212          | —              | 21,054       |
|                 | \$ 164,072                       | \$ 526,183  | \$ 302,539        | \$ 26,824    | \$ 27,001      | \$ 1,046,619 |

## Allowance for Loan Losses

An allowance for loan losses (“ALL”) is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated future loss experience, and the amount of non-performing loans.

The Banks' methodology for determining the ALL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (previously discussed) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Banks' ALL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. Allowances are segmented based on collateral characteristics previously disclosed, and consistent with credit quality monitoring. Loans that are collectively evaluated for impairment are grouped into two classes for evaluation. A general allowance is determined for “Pass” rated credits, while a separate pool allowance is provided for “Criticized” rated credits that are not individually evaluated for impairment.

For the general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors. A historical charge-off factor is calculated utilizing a twelve quarter moving average. However, management may adjust the moving average time frame by up to four quarters to adjust for variances in the economic cycle. Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency rates and non-accrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability,

and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors. Management also monitors industry loss factors by loan segment for applicable adjustments to actual loss experience.

Management reviews the loan portfolio on a quarterly basis in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

Activity in the allowance is presented for the three months ended March 31, 2016 and 2015:

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| (In Thousands)    | Three Months Ended March 31, 2016               |   |            |              |                                     |             |          |
|-------------------|---|---|------------|--------------|-------------------------------------|-------------|----------|
|                   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial | Construction | Installment Loans<br>to Individuals | Unallocated | Totals   |
| Beginning Balance | \$1,532   | \$5,116                                 | \$4,217    | \$160        | \$243                               | \$776       | \$12,044 |
| Charge-offs       | —   | —                                       | —          | —            | (51)                                | —           | (51)     |
| Recoveries        | —   | 3                                       | 5          | 3            | 28                                  | —           | 39       |
| Provision         | (278)   | 4                                       | 250        | (16)         | 44                                  | 346         | 350      |
| Ending Balance    | \$1,254   | \$5,123                                 | \$4,472    | \$147        | \$264                               | \$1,122     | \$12,382 |

| (In Thousands)    | Three Months Ended March 31, 2015               |   |            |              |                                     |             |          |
|-------------------|---|---|------------|--------------|-------------------------------------|-------------|----------|
|                   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial | Construction | Installment Loans<br>to Individuals | Unallocated | Totals   |
| Beginning Balance | \$1,124   | \$3,755                                 | \$4,205    | \$786        | \$245                               | \$464       | \$10,579 |
| Charge-offs       | (20)  | (1)                                     | (449)      | —            | (56)                                | —           | (526)    |
| Recoveries        | 26  | 24                                      | —          | 11           | 12                                  | —           | 73       |
| Provision         | 348   | 449                                     | 117        | (45)         | (8)                                 | (161)       | 700      |
| Ending Balance    | \$1,478   | \$4,227                                 | \$3,873    | \$752        | \$193                               | \$303       | \$10,826 |

The Company grants commercial, industrial, residential, and installment loans to customers primarily throughout north-east and central Pennsylvania. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

The Company has a concentration of the following to gross loans at March 31, 2016 and 2015:

|   | March 31, |        |
|---|-----------|--------|
|   | 2016      | 2015   |
| Owners of residential rental properties | 16.27%    | 16.20% |
| Owners of commercial rental properties  | 14.27%    | 14.46% |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment based on impairment method as of March 31, 2016 and December 31, 2015:

| (In Thousands)                                  | March 31, 2016                                  |   |            |              |                                     |             |         |
|---|---|---|------------|--------------|-------------------------------------|-------------|---------|
|   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial | Construction | Installment Loans<br>to Individuals | Unallocated | Totals  |
| Allowance for Loan Losses:                      |   |   |            |              |                                     |             |         |
| Ending allowance balance attributable to loans: |   |   |            |              |                                     |             |         |
| Individually evaluated for impairment           | \$219   | \$353                                   | \$1,984    | \$—          | \$—                                 | \$—         | \$2,556 |
|   | 1,035   | 4,770                                   | 2,488      | 147          | 264                                 | 1,122       | 9,826   |

Collectively evaluated for  
impairment

|                                |         |         |         |       |       |         |          |
|--------------------------------|---------|---------|---------|-------|-------|---------|----------|
| Total ending allowance balance | \$1,254 | \$5,123 | \$4,472 | \$147 | \$264 | \$1,122 | \$12,382 |
|--------------------------------|---------|---------|---------|-------|-------|---------|----------|

Loans:

|  |       |         |          |       |     |  |          |
|--|-------|---------|----------|-------|-----|--|----------|
| Individually evaluated for<br>impairment | \$595 | \$2,794 | \$13,196 | \$279 | \$— |  | \$16,864 |
|--|-------|---------|----------|-------|-----|--|----------|

|  |   |     |   |   |   |  |     |
|--|---|-----|---|---|---|--|-----|
| Loans acquired with deteriorated<br>credit quality | — | 337 | — | — | — |  | 337 |
|--|---|-----|---|---|---|--|-----|

|  |         |         |         |        |        |  |           |
|--|---------|---------|---------|--------|--------|--|-----------|
| Collectively evaluated for<br>impairment | 152,296 | 528,293 | 293,063 | 25,110 | 26,702 |  | 1,025,464 |
|--|---------|---------|---------|--------|--------|--|-----------|

|                            |           |           |           |          |          |  |             |
|----------------------------|-----------|-----------|-----------|----------|----------|--|-------------|
| Total ending loans balance | \$152,891 | \$531,424 | \$306,259 | \$25,389 | \$26,702 |  | \$1,042,665 |
|----------------------------|-----------|-----------|-----------|----------|----------|--|-------------|

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| (In Thousands)                                  | December 31, 2015                               |                            |                         |              |  |             |             |
|---|---|----------------------------|-------------------------|--------------|--|-------------|-------------|
|   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Residential | Mortgages<br>Commercial | Construction | Installment<br>Loans<br>to Individuals | Unallocated | Totals      |
| Allowance for Loan Losses:                      |   |                            |                         |              |  |             |             |
| Ending allowance balance attributable to loans: |   |                            |                         |              |  |             |             |
| Individually evaluated for impairment           | \$75  | \$376                      | \$1,653                 | \$—          | \$—                                    | \$—         | \$2,104     |
| Collectively evaluated for impairment           | 1,457   | 4,740                      | 2,564                   | 160          | 243                                    | 776         | 9,940       |
| Total ending allowance balance                  | \$1,532   | \$5,116                    | \$4,217                 | \$160        | \$243                                  | \$776       | \$12,044    |
| Loans:  |   |                            |                         |              |  |             |             |
| Individually evaluated for impairment           | \$469   | \$2,374                    | \$12,487                | \$212        | \$—                                    |             | \$15,542    |
| Loans acquired with deteriorated credit quality | —   | 341                        | —                       | —            | —                                      |             | 341         |
| Collectively evaluated for impairment           | 163,603   | 523,468                    | 290,052                 | 26,612       | 27,001                                 |             | 1,030,736   |
| Total ending loans balance                      | \$164,072                                       | \$526,183                  | \$302,539               | \$26,824     | \$27,001                               |             | \$1,046,619 |

## Note 7. Net Periodic Benefit Cost-Defined Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 13 of the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2015.

The following sets forth the components of the net periodic benefit/cost of the domestic non-contributory defined benefit plan for the three months ended March 31, 2016 and 2015, respectively:

| (In Thousands)                 | Three<br>Months<br>Ended<br>March 31, |        |
|--------------------------------|---------------------------------------|--------|
|                                | 2016                                  | 2015   |
| Service cost                   | \$17                                  | \$16   |
| Interest cost                  | 193                                   | 189    |
| Expected return on plan assets | (251)                                 | (281)  |
| Amortization of net loss       | 39                                    | 40     |
| Net periodic benefit cost      | \$(2)                                 | \$(36) |

## Employer Contributions

The Company previously disclosed in its consolidated financial statements, included in the Annual Report on Form 10-K for the year ended December 31, 2015, that it expected to contribute a minimum of \$500,000 to its defined benefit plan in 2016. As of March 31, 2016, there were contributions of \$250,000 made to the plan with additional

contributions of at least \$250,000 anticipated during the remainder of 2016.

Note 8. Employee Stock Purchase Plan

The Company maintains an Employee Stock Purchase Plan (“Plan”). The Plan is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the three months ended March 31, 2016 and 2015, there were 550 and 520 shares issued under the plan, respectively.

Note 9. Off Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments are primarily comprised of commitments to extend credit, standby letters of credit, and credit exposure from the sale of assets with recourse. These instruments involve, to varying degrees, elements of credit,

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interest rate, or liquidity risk in excess of the amount recognized in the Consolidated Balance Sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support financial instruments with off-balance sheet credit risk.

Financial instruments whose contract amounts represent credit risk are as follows at March 31, 2016 and December 31, 2015:

| (In Thousands)  | March 31, December 31, |           |
|---|------------------------|-----------|
|   | 2016                   | 2015      |
| Commitments to extend credit                          | \$247,801              | \$241,936 |
| Standby letters of credit                             | 5,402                  | 4,786     |
| Credit exposure from the sale of assets with recourse | 7,167                  | 6,523     |
|   | \$260,370              | \$253,245 |

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, on an extension of credit is based on management's credit assessment of the counterparty.

Standby letters of credit represent conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid or performance related contracts. The coverage period for these instruments is typically a one year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized upon expiration of the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

#### Note 10. Fair Value Measurements

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value.

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.

This hierarchy requires the use of observable market data when available.

The following table presents the assets reported on the balance sheet at their fair value on a recurring basis as of March 31, 2016 and December 31, 2015, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

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| (In Thousands)                             | March 31, 2016 |           |           |            |
|--|----------------|-----------|-----------|------------|
|  | Level I        | Level II  | Level III | Total      |
| Assets measured on a recurring basis:      |                |           |           |            |
| Investment securities, available for sale: |                |           |           |            |
| U.S. Government and agency securities      | \$—            | \$3,476   | \$        | —\$3,476   |
| Mortgage-backed securities                 | —              | 9,751     | —         | 9,751      |
| Asset-backed securities                    | —              | 1,793     | —         | 1,793      |
| State and political securities             | —              | 70,575    | —         | 70,575     |
| Other debt securities                      | —              | 56,215    | —         | 56,215     |
| Financial institution equity securities    | 9,735          | —         | —         | 9,735      |
| Other equity securities                    | 2,164          | —         | —         | 2,164      |
| Investment securities, trading:            |                |           |           |            |
| Financial institution equity securities    | 60             | —         | —         | 60         |
| Total assets measured on a recurring basis | \$11,959       | \$141,810 | \$        | —\$153,769 |

| (In Thousands)                             | December 31, 2015 |           |           |            |
|--|-------------------|-----------|-----------|------------|
|  | Level I           | Level II  | Level III | Total      |
| Assets measured on a recurring basis:      |                   |           |           |            |
| Investment securities, available for sale: |                   |           |           |            |
| U.S. Government and agency securities      | \$—               | \$3,549   | \$        | —\$3,549   |
| Mortgage-backed securities                 | —                 | 10,009    | —         | 10,009     |
| Asset-backed securities                    | —                 | 1,940     | —         | 1,940      |
| State and political securities             | —                 | 86,555    | —         | 86,555     |
| Other debt securities                      | —                 | 57,772    | —         | 57,772     |
| Financial institution equity securities    | 11,483            | —         | —         | 11,483     |
| Other equity securities                    | 4,849             | —         | —         | 4,849      |
| Investment securities, trading:            |                   |           |           |            |
| Financial institution equity securities    | 73                | —         | —         | 73         |
| Total assets measured on a recurring basis | \$16,405          | \$159,825 | \$        | —\$176,230 |

The following table presents the assets reported on the Consolidated Balance Sheet at their fair value on a non-recurring basis as of March 31, 2016 and December 31, 2015, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (In Thousands)                                 | March 31, 2016 |           |           |       |
|--|----------------|-----------|-----------|-------|
|  | Level I        | Level II  | Level III | Total |
| Assets measured on a non-recurring basis:      |                |           |           |       |
| Impaired loans                                 | \$—            | —\$14,645 | \$14,645  |       |
| Other real estate owned                        | —              | 1,719     | 1,719     |       |
| Total assets measured on a non-recurring basis | \$—            | —\$16,364 | \$16,364  |       |

| (In Thousands)                                 | December 31, 2015 |           |           |       |
|--|-------------------|-----------|-----------|-------|
|  | Level I           | Level II  | Level III | Total |
| Assets measured on a non-recurring basis:      |                   |           |           |       |
| Impaired loans                                 | \$—               | —\$13,779 | \$13,779  |       |
| Other real estate owned                        | —                 | 1,696     | 1,696     |       |
| Total assets measured on a non-recurring basis | \$—               | —\$15,475 | \$15,475  |       |



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The following tables present a listing of significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques as of March 31, 2016 and December 31, 2015:

March 31, 2016

Quantitative Information About Level III Fair Value Measurements

| (In Thousands)          | Fair Value | Valuation Technique(s)      | Unobservable Inputs                   | Range      | Weighted Average |
|-------------------------|------------|-----------------------------|---------------------------------------|------------|------------------|
| Impaired loans          | \$5,370    | Discounted cash flow        | Temporary reduction in payment amount | 0 to (70)% | (16)%            |
|                         | 9,275      | Appraisal of collateral     | Appraisal adjustments (1)             | 0 to (20)% | (13)%            |
| Other real estate owned | \$1,719    | Appraisal of collateral (1) |                                       |            |                  |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

December 31, 2015

Quantitative Information About Level III Fair Value Measurements

| (In Thousands)          | Fair Value | Valuation Technique(s)      | Unobservable Inputs                   | Range      | Weighted Average |
|-------------------------|------------|-----------------------------|---------------------------------------|------------|------------------|
| Impaired loans          | \$5,696    | Discounted cash flow        | Temporary reduction in payment amount | 0 to (70)% | (17)%            |
|                         | 8,083      | Appraisal of collateral     | Appraisal adjustments (1)             | 0 to (20)% | (15)%            |
| Other real estate owned | \$1,696    | Appraisal of collateral (1) |                                       |            |                  |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The significant unobservable inputs used in the fair value measurement of the Company's impaired loans using the discounted cash flow valuation technique include temporary changes in payment amounts and the probability of default. Significant increases (decreases) in payment amounts would result in significantly higher (lower) fair value measurements. The probability of default is 0% for impaired loans using the discounted cash flow valuation technique because all defaulted impaired loans are valued using the appraisal of collateral valuation technique.

The significant unobservable input used in the fair value measurement of the Company's impaired loans using the appraisal of collateral valuation technique include appraisal adjustments, which are adjustments to appraisals by management for qualitative factors such as economic conditions and estimated liquidation expenses. The significant unobservable input used in the fair value measurement of the Company's other real estate owned are the same inputs used to value impaired loans using the appraisal of collateral valuation technique.

#### Note 11. Fair Value of Financial Instruments

The Company is required to disclose fair values for its financial instruments. Fair values are made at a specific point in time, 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. Also, it is the Company's general practice and intention to hold most of its financial instruments to maturity and not to engage in trading or sales activities. 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 fair values 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 fair values.

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

As certain assets and liabilities, such as deferred tax assets, premises and equipment, and many other operational elements of the Company, are not considered financial instruments but have value, this fair value of financial instruments would not represent the full market value of the Company.

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The fair values of the Company's financial instruments are as follows at March 31, 2016 and December 31, 2015:

| (In Thousands)                               | Carrying Value | Fair Value | Fair Value Measurements at March 31, 2016 |          |            |
|--|----------------|------------|---|----------|------------|
|  |                |            | Level I                                   | Level II | Level III  |
| Financial assets:                            |                |            |   |          |            |
| Cash and cash equivalents                    | \$47,125       | \$47,125   | \$ 47,125                                 | \$ —     | \$ —       |
| Investment securities:                       |                |            |   |          |            |
| Available for sale                           | 153,709        | 153,709    | 11,899                                    | 141,810  | —          |
| Trading                                      | 60             | 60         | 60  | —        | —          |
| Loans held for sale                          | 514            | 514        | 514                                       | —        | —          |
| Loans, net                                   | 1,028,870      | 1,068,941  | —   | —        | 1,068,941  |
| Bank-owned life insurance                    | 26,867         | 26,867     | 26,867                                    | —        | —          |
| Accrued interest receivable                  | 3,878          | 3,878      | 3,878                                     | —        | —          |
| Financial liabilities:                       |                |            |   |          |            |
| Interest-bearing deposits                    | \$790,219      | \$779,632  | \$ 558,909                                | \$ —     | \$ 220,723 |
| Noninterest-bearing deposits                 | 269,362        | 269,362    | 269,362                                   | —        | —          |
| Short-term borrowings                        | 15,874         | 15,874     | 15,874                                    | —        | —          |
| Long-term borrowings                         | 91,025         | 92,582     | —   | —        | 92,582     |
| Accrued interest payable                     | 439            | 439        | 439                                       | —        | —          |
| Fair Value Measurements at December 31, 2015 |                |            |   |          |            |
| (In Thousands)                               | Carrying Value | Fair Value | Level I                                   | Level II | Level III  |
| Financial assets:                            |                |            |   |          |            |
| Cash and cash equivalents                    | \$22,796       | \$22,796   | \$ 22,796                                 | \$ —     | \$ —       |
| Investment securities:                       |                |            |   |          |            |
| Available for sale                           | 176,157        | 176,157    | 16,332                                    | 159,825  | —          |
| Trading                                      | 73             | 73         | 73  | —        | —          |
| Loans held for sale                          | 757            | 757        | 757                                       | —        | —          |
| Loans, net                                   | 1,033,163      | 1,045,140  | —   | —        | 1,045,140  |
| Bank-owned life insurance                    | 26,667         | 26,667     | 26,667                                    | —        | —          |
| Accrued interest receivable                  | 3,686          | 3,686      | 3,686                                     | —        | —          |
| Financial liabilities:                       |                |            |   |          |            |
| Interest-bearing deposits                    | \$751,797      | \$729,685  | \$ 509,206                                | \$ —     | \$ 220,479 |

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|                              |         |         |         |   |        |
|------------------------------|---------|---------|---------|---|--------|
| Noninterest-bearing deposits | 280,083 | 280,083 | 280,083 | — | —      |
| Short-term borrowings        | 46,638  | 46,638  | 46,638  | — | —      |
| Long-term borrowings         | 91,025  | 91,783  | —       | — | 91,783 |
| Accrued interest payable     | 426     | 426     | 426     | — | —      |

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Cash and Cash Equivalents, Loans Held for Sale, Accrued Interest Receivable, Short-term Borrowings, and Accrued Interest Payable:

The fair value is equal to the carrying value.

Investment Securities:

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

Regulatory stocks' fair value is equal to the carrying value.

Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, financial, and agricultural, commercial real estate, residential real estate, construction real estate, and installment loans to individuals. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans 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.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discounted rates are judgmentally determined using available market information and specific borrower information.

Bank-Owned Life Insurance:

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

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW, 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 fair value estimates above 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.

Long Term Borrowings:

The fair value of long term borrowings is based on the discounted value of contractual cash flows.

Commitments to Extend Credit, Standby Letters of Credit, and Financial Guarantees Written:

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items. The contractual amounts of unfunded commitments and letters of credit are presented in Note 9 (Off Balance Sheet Risk).

Note 12. Stock Options



In 2014, the Company adopted the 2014 Equity Incentive Plan designed to help the Company attract, retain, and motivate employees and non-employee directors. Incentive stock options, non-qualified stock options, and restricted stock may be granted as part of the plan.

On August 27, 2015, the Company issued 38,750 stock options to a group of employees. Each option granted has a strike price of \$42.03 and is exercisable only after five years following the date of the grant of such options. The options expire ten years following the date of the grant of such options.

A summary of stock option activity is presented below:

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|                                | March 31, 2016 |                                 | December 31, 2015 |                                 |
|--------------------------------|----------------|---------------------------------|-------------------|---------------------------------|
|                                | Shares         | Weighted Average Exercise Price | Shares            | Weighted Average Exercise Price |
| Outstanding, beginning of year | 34,750         | \$ 42.03                        | —                 | \$ —                            |
| Granted                        | —              | —                               | 38,750            | 42.03                           |
| Exercised                      | —              | —                               | —                 | —                               |
| Forfeited                      | (2,250 )       | 42.03                           | (4,000 )          | 42.03                           |
| Outstanding, end of year       | 32,500         | \$ 42.03                        | 34,750            | \$ 42.03                        |

The estimated fair value of options, including the effect of estimated forfeitures, is recognized as expense on a straightline basis over the options' vesting periods while ensuring that the cumulative amount of compensation cost recognized at least equals the value of the vested portion of the award at that date. The Company determines the fair value of options granted using the Black-Scholes option-pricing model. The risk-free interest rate is based on the United States Treasury bond with a similar term to the expected life of the options at the grant date. Expected volatility was estimated based on the adjusted historic volatility of the Company's shares. The expected life was estimated to equal the contractual life of the options. The dividend yield rate was based upon recent historical dividends paid on shares.

#### Note 13. Reclassification of Comparative Amounts

Certain comparative amounts for the prior period have been reclassified to conform to current period presentations. Such reclassifications had no effect on net income or shareholders' equity.

#### CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report contains certain "forward-looking statements" including statements concerning plans, objectives, future events or performance and assumptions and other statements which are other than statements of historical fact. The Company cautions readers that the following important factors, among others, may have affected and 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 made by or on behalf of the Company herein: (i) the effect of changes in laws and regulations, including federal and state banking laws and regulations, with which the Company must comply, and the associated costs of compliance with such laws and regulations either currently or in the future as applicable; (ii) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies as well as by the Financial Accounting Standards Board, or of changes in the Company's organization, compensation and benefit plans; (iii) the effect on the Company's competitive position within its market area of the increasing consolidation within the banking and financial services industries, including the increased competition from larger regional and out-of-state banking organizations as well as non-bank providers of various financial services; (iv) the effect of changes in interest rates; (v) the effect of changes in the business cycle and downturns in the local, regional or national economies; and (vi) the Risk Factors identified in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2015 and in other filings made by the Company under the Securities Exchange Act of 1934.

You should not put undue reliance on any forward-looking statements. These statements speak only as of the date of this Quarterly Report on Form 10-Q, even if subsequently made available by the Company on its website or otherwise. The Company undertakes no obligation to update or revise these statements to reflect events or circumstances occurring after the date of this Quarterly Report on Form 10-Q.

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## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

## EARNINGS SUMMARY

## Comparison of the Three Months Ended March 31, 2016 and 2015

## Summary Results

The three months ended March 31, 2016 generated net income of \$3,078,000 compared to \$3,355,000 for the same period of 2015. Comparable results were impacted by a decrease in after-tax securities gains of \$122,000 (from a gain of \$436,000 to a gain of \$314,000). Earnings per share, basic and dilutive, for the three months ended March 31, 2016 were \$0.65 compared to \$0.70 for the comparable period of 2015. Return on average assets and return on average equity were 0.94% and 8.95% for the three months ended March 31, 2016 compared to 1.06% and 9.76% for the corresponding period of 2015. Operating earnings decreased to \$2,764,000 for the three months ended March 31, 2016 compared to \$2,919,000 for the same period of 2015, as the 2015 period included non-recurring gains on the sale of other real estate owned of \$270,000. Operating earnings per share for the three months ended March 31, 2016 were \$0.58 basic and dilutive compared to \$0.61 basic and dilutive for the three months ended March 31, 2015.

Management uses the non-GAAP measure of net income from core operations, or operating earnings, in its analysis of the Company's performance. This measure, as used by the Company, adjusts net income by excluding significant gains or losses that are unusual in nature. Because certain of these items and their impact on the Company's performance are difficult to predict, management believes the presentation of financial measures excluding the impact of such items provides useful supplemental information in evaluating the operating results of the Company's core businesses. For purposes of this Quarterly Report on Form 10-Q, net income from core operations, or operating earnings, means net income adjusted to exclude after-tax net securities gains or losses and bank-owned life insurance gains on death benefit. These disclosures should not be viewed as a substitute for net income determined in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

## Reconciliation of GAAP and Non-GAAP Financial Measures

|   | Three Months<br>Ended March<br>31, |         |
|---|------------------------------------|---------|
| (Dollars in Thousands, Except Per Share Data) | 2016                               | 2015    |
| GAAP net income                               | \$3,078                            | \$3,355 |
| Less: net securities, net of tax              | 314                                | 436     |
| Non-GAAP operating earnings                   | \$2,764                            | \$2,919 |

|                                  | Three Months<br>Ended March<br>31, |       |
|----------------------------------|------------------------------------|-------|
|                                  | 2016                               | 2015  |
| Return on average assets (ROA)   | 0.94%                              | 1.06% |
| Less: net securities, net of tax | 0.10%                              | 0.13% |
| Non-GAAP operating ROA           | 0.84%                              | 0.93% |

Three Months  
Ended March  
31,

|                                  | 2016      | 2015   |
|----------------------------------|-----------|--------|
| Return on average equity (ROE)   | 8.95%     | 9.76%  |
| Less: net securities, net of tax | 0.91%     | 1.27%  |
| Non-GAAP operating ROE           | 8.04%     | 8.49%  |
|                                  | Three     |        |
|                                  | Months    |        |
|                                  | Ended     |        |
|                                  | March 31, |        |
|                                  | 2016      | 2015   |
| Basic earnings per share (EPS)   | \$0.65    | \$0.70 |
| Less: net securities, net of tax | 0.07      | 0.09   |
| Non-GAAP basic operating EPS     | \$0.58    | \$0.61 |

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|                                  | Three<br>Months<br>Ended<br>March 31,<br>2016 2015 |        |
|----------------------------------|--|--------|
| Dilutive EPS                     | \$0.65   | \$0.70 |
| Less: net securities, net of tax | 0.07   | 0.09   |
| Non-GAAP dilutive operating EPS  | \$0.58   | \$0.61 |

## Interest and Dividend Income

Interest and dividend income for the three months ended March 31, 2016 increased to \$11,726,000 compared to \$11,397,000 for the same period of 2015. Loan portfolio income increased as the impact of portfolio growth, due primarily to an increase in home equity products, offset a reduction in yield of 7 basis points (“bp”) due to the competitive landscape and the continued low rate environment that is impacting new loan rates as well as the variable rate segment of the loan portfolio. The loan portfolio income increase was offset by a decrease in investment portfolio interest due to a decline in the average taxable equivalent yield of 31 bp as the duration in the investment portfolio continues to be shortened in order to reduce interest rate and market risk in the future. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. To offset the revenue impact of the declining asset yields, a focus has been placed on increasing earning assets by adding quality short and intermediate term loans such as home equity loans, even though these new earning assets are at lower yields than legacy assets.

Interest and dividend income composition for the three months ended March 31, 2016 and 2015 was as follows:

| (In Thousands)                     | Three Months Ended |         |                |         |         |         |
|------------------------------------|--------------------|---------|----------------|---------|---------|---------|
|                                    | March 31, 2016     |         | March 31, 2015 |         | Change  |         |
|                                    | Amount             | % Total | Amount         | % Total | Amount  | %       |
| Loans including fees               | \$10,355           | 88.31 % | \$9,323        | 81.80 % | \$1,032 | 11.07 % |
| Investment securities:             |                    |         |                |         |         |         |
| Taxable                            | 622                | 5.30    | 1,014          | 8.90    | (392 )  | (38.66) |
| Tax-exempt                         | 475                | 4.05    | 767            | 6.73    | (292 )  | (38.07) |
| Dividend and other interest income | 274                | 2.34    | 293            | 2.57    | (19 )   | (6.48 ) |
| Total interest and dividend income | \$11,726           | 100.00% | \$11,397       | 100.00% | \$329   | 2.89 %  |

## Interest Expense

Interest expense for the three months ended March 31, 2016 increased \$66,000 to \$1,352,000 compared to \$1,286,000 for the same period of 2015. The increase in interest expense is primarily associated with the lengthening of the time deposit portfolio as part of a strategy to build balance sheet protection in a rising rate environment, coupled with an increase in short term borrowing utilization.

Interest expense composition for the three months ended March 31, 2016 and 2015 was as follows:

| (In Thousands) | Three Months Ended |         |                |         |        |         |
|----------------|--------------------|---------|----------------|---------|--------|---------|
|                | March 31, 2016     |         | March 31, 2015 |         | Change |         |
|                | Amount             | % Total | Amount         | % Total | Amount | %       |
| Deposits       | \$834              | 61.69 % | \$743          | 57.77 % | \$91   | 12.25 % |

|                        |         |         |         |         |       |         |
|------------------------|---------|---------|---------|---------|-------|---------|
| Short-term borrowings  | 26      | 1.92    | 19      | 1.48    | 7     | 36.84   |
| Long-term borrowings   | 492     | 36.39   | 524     | 40.75   | (32 ) | (6.11 ) |
| Total interest expense | \$1,352 | 100.00% | \$1,286 | 100.00% | \$66  | 5.13 %  |

Net Interest Margin

The net interest margin (“NIM”) for the three months ended March 31, 2016 was 3.57% compared to 3.69% for the corresponding period of 2015. The decline in the net interest margin was driven by a decreasing yield on the loan and investment portfolios due

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to the continued low rate environment. The impact of the declining earning asset yield and decreasing investment portfolio balance was partially offset by 12.35% growth in the balance of the average loan portfolio from March 31, 2015 to March 31, 2016 resulting in net interest income on a taxable equivalent basis increasing slightly compared to the comparable three month period of 2015. The primary funding for the loan growth was an increase in core deposits. These deposits represent a lower cost funding source than time deposits and comprise 79.22% of total deposits at March 31, 2016 compared to 78.33% at March 31, 2015. Limiting the positive impact on the net interest margin caused by the growth in core deposits was the lengthening of the time deposit portfolio coupled with additional FHLB long-term borrowings as part of our strategy to prepare the balance sheet for a rising rate environment.

The following is a schedule of average balances and associated yields for the three months ended March 31, 2016 and 2015:

| (In Thousands)                               | AVERAGE BALANCES AND INTEREST RATES |          |              |   |                                   |          |              |   |
|--|-------------------------------------|----------|--------------|---|-----------------------------------|----------|--------------|---|
|  | Three Months Ended March 31, 2016   |          |              |   | Three Months Ended March 31, 2015 |          |              |   |
|  | Average Balance                     | Interest | Average Rate |   | Average Balance                   | Interest | Average Rate |   |
| <b>Assets:</b>                               |                                     |          |              |   |                                   |          |              |   |
| Tax-exempt loans                             | \$54,014                            | \$535    | 3.98         | % | \$36,183                          | \$383    | 4.30         | % |
| All other loans                              | 988,632                             | 10,002   | 4.07         | % | 891,877                           | 9,070    | 4.12         | % |
| Total loans                                  | 1,042,646                           | 10,537   | 4.06         | % | 928,060                           | 9,453    | 4.13         | % |
| Taxable securities                           | 99,032                              | 885      | 3.57         | % | 143,421                           | 1,303    | 3.63         | % |
| Tax-exempt securities                        | 63,373                              | 720      | 4.54         | % | 87,825                            | 1,162    | 5.29         | % |
| Total securities                             | 162,405                             | 1,605    | 3.95         | % | 231,246                           | 2,465    | 4.26         | % |
| Interest-bearing deposits                    | 12,693                              | 11       | 0.35         | % | 6,539                             | 4        | 0.25         | % |
| Total interest-earning assets                | 1,217,744                           | 12,153   | 4.01         | % | 1,165,845                         | 11,922   | 4.14         | % |
| Other assets                                 | 96,462                              |          |              |   | 96,043                            |          |              |   |
| Total assets                                 | \$1,314,206                         |          |              |   | \$1,261,888                       |          |              |   |
| <b>Liabilities and shareholders' equity:</b> |                                     |          |              |   |                                   |          |              |   |
| Savings                                      | \$148,856                           | 14       | 0.04         | % | \$141,762                         | 14       | 0.04         | % |
| Super Now deposits                           | 188,147                             | 125      | 0.27         | % | 190,438                           | 129      | 0.27         | % |
| Money market deposits                        | 219,240                             | 139      | 0.25         | % | 205,243                           | 136      | 0.27         | % |
| Time deposits                                | 220,554                             | 556      | 1.01         | % | 216,775                           | 464      | 0.87         | % |
| Total interest-bearing deposits              | 776,797                             | 834      | 0.43         | % | 754,218                           | 743      | 0.40         | % |
| Short-term borrowings                        | 28,410                              | 26       | 0.36         | % | 28,229                            | 19       | 0.27         | % |
| Long-term borrowings                         | 91,025                              | 492      | 2.14         | % | 84,009                            | 524      | 2.50         | % |
| Total borrowings                             | 119,435                             | 518      | 1.72         | % | 112,238                           | 543      | 1.94         | % |
| Total interest-bearing liabilities           | 896,232                             | 1,352    | 0.60         | % | 866,456                           | 1,286    | 0.60         | % |
| Demand deposits                              | 265,053                             |          |              |   | 240,750                           |          |              |   |
| Other liabilities                            | 15,406                              |          |              |   | 17,145                            |          |              |   |



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|  |             |          |      |             |          |      |   |
|--|-------------|----------|------|-------------|----------|------|---|
| Shareholders' equity                       | 137,515     |          |      | 137,537     |          |      |   |
| Total liabilities and shareholders' equity | \$1,314,206 |          |      | \$1,261,888 |          |      |   |
| Interest rate spread                       |             | 3.41     | %    |             | 3.54     | %    |   |
| Net interest income/margin                 |             | \$10,801 | 3.57 | %           | \$10,636 | 3.69 | % |

1. Information on this table has been calculated using average daily balance sheets to obtain average balances.
2. Non-accrual loans have been included with loans for the purpose of analyzing net interest earnings.
3. Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.

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The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three months ended March 31, 2016 and 2015.

| (In Thousands)                                 | Three Months<br>Ended March 31, |          |
|--|---------------------------------|----------|
|  | 2016                            | 2015     |
| Total interest income                          | \$11,726                        | \$11,397 |
| Total interest expense                         | 1,352                           | 1,286    |
| Net interest income                            | 10,374                          | 10,111   |
| Tax equivalent adjustment                      | 427                             | 525      |
| Net interest income (fully taxable equivalent) | \$10,801                        | \$10,636 |

The following table sets forth the respective impact that both volume and rate changes have had on net interest income on a fully taxable equivalent basis for the three months ended March 31, 2016 and 2015:

| (In Thousands)                     | Three Months Ended<br>March 31,<br>2016 vs. 2015 |           |        |
|------------------------------------|--|-----------|--------|
|                                    | Volume   | Rate      | Net    |
| Interest income:                   |  |           |        |
| Tax-exempt loans                   | \$ 334   | \$ (182 ) | \$ 152 |
| All other loans                    | 1,640  | (708 )    | 932    |
| Taxable investment securities      | (397 )   | (21 )     | (418 ) |
| Tax-exempt investment securities   | (293 )   | (149 )    | (442 ) |
| Interest bearing deposits          | 5  | 2         | 7      |
| Total interest-earning assets      | 1,289  | (1,058 )  | 231    |
| Interest expense:                  |  |           |        |
| Savings deposits                   | —  | —         | —      |
| Super Now deposits                 | (4 )   | —         | (4 )   |
| Money market deposits              | 41   | (38 )     | 3      |
| Time deposits                      | —  | 92        | 92     |
| Short-term borrowings              | —  | 7         | 7      |
| Long-term borrowings               | 210  | (242 )    | (32 )  |
| Total interest-bearing liabilities | 247  | (181 )    | 66     |
| Change in net interest income      | \$ 1,042   | \$ (877 ) | \$ 165 |

## Provision for Loan Losses

The provision for loan losses is based upon management's quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Banks. Management remains committed to an aggressive program of problem loan identification and resolution.

The allowance for loan losses is determined by applying loss factors to outstanding loans by type, excluding loans for which a specific allowance has been determined. Loss factors are based on management's consideration of the nature of the portfolio segments, changes in mix and volume of the loan portfolio, and historical loan loss experience. In addition, management considers industry standards and trends with respect to non-performing loans and its knowledge and experience with specific lending segments.

Although management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate at March 31, 2016, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, increased unemployment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming

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assets, charge-offs, loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Banks' loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

When determining the appropriate allowance level, management has attributed the allowance for loan losses to various portfolio segments; however, the allowance is available for the entire portfolio as needed.

The allowance for loan losses increased from \$12,044,000 at December 31, 2015 to \$12,382,000 at March 31, 2016. The increase in the allowance for loan losses was driven by an increase in total nonperforming loans. In addition the portfolio experienced minimal net charge-offs during the three months ended March 31, 2016 of \$12,000. The majority of the loans charged-off had a specific allowance within the allowance for losses. At March 31, 2016 and December 31, 2015, the allowance for loan losses to total loans was 1.19% and 1.15%, respectively.

The provision for loan losses totaled \$350,000 and \$700,000 for the three months ended March 31, 2016 and 2015. The amount of the provision for loan losses was primarily the result of loan growth.

Nonperforming loans increasing to \$11,648,000 at March 31, 2016 from \$11,157,000 at March 31, 2015 is primarily the result of a large commercial real estate loan that was placed on non-accrual status. The ratio of nonperforming loans to total loans was 1.12% and 1.18% at March 31, 2016 and 2015, respectively, and the ratio of the allowance for loan losses to nonperforming loans was 106.30% and 97.03% at March 31, 2016 and 2015, respectively. Internal loan review and analysis coupled with loan growth dictated a provision for loan losses of \$350,000 for the three months ended March 31, 2016.

The following is a table showing total nonperforming loans as of:

| (In Thousands)     | Total Nonperforming Loans |            |           |
|--------------------|---------------------------|------------|-----------|
|                    | 90 Days Past Due          | Nonaccrual | Total     |
| March 31, 2016     | \$ 308                    | \$ 11,340  | \$ 11,648 |
| December 31, 2015  | 979                       | 8,467      | 9,446     |
| September 30, 2015 | 99                        | 8,509      | 8,608     |
| June 30, 2015      | 890                       | 8,799      | 9,689     |
| March 31, 2015     | 391                       | 10,766     | 11,157    |

#### Non-interest Income

Total non-interest income for the three months ended March 31, 2016 compared to the same period in 2015 decreased \$263,000 to \$2,997,000. Excluding net securities gains, non-interest income for the three months ended March 31, 2016 decreased \$77,000 compared to the same period in 2015. The increase in gain on sale of loans was driven by a shift in distribution channels and the hiring of additional mortgage loan officers over the past year. The decrease in other non-interest income is the result of a gain on sale of other real-estate of \$270,000 during 2015.



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Non-interest income composition for the three months ended March 31, 2016 and 2015 was as follows:

| (In Thousands)                           | Three Months Ended |         |                |         |         |          |
|--|--------------------|---------|----------------|---------|---------|----------|
|  | March 31, 2016     |         | March 31, 2015 |         | Change  |          |
|  | Amount             | % Total | Amount         | % Total | Amount  | %        |
| Service charges                          | \$532              | 17.75 % | \$553          | 16.96 % | \$(21 ) | (3.80 )% |
| Net securities gains, available for sale | 435                | 14.51   | 661            | 20.27   | (226 )  | (34.19 ) |
| Net securities gains, trading            | 40                 | 1.33    | —              | —       | 40      | (100.00) |
| Bank-owned life insurance                | 184                | 6.14    | 188            | 5.77    | (4 )    | (2.13 )  |
| Gain on sale of loans                    | 467                | 15.58   | 299            | 9.17    | 168     | 56.19    |
| Insurance commissions                    | 206                | 6.87    | 234            | 7.18    | (28 )   | (11.97 ) |
| Brokerage commissions                    | 255                | 8.51    | 245            | 7.52    | 10      | 4.08     |
| Other                                    | 878                | 29.31   | 1,080          | 33.13   | (202 )  | (18.70 ) |
| Total non-interest income                | \$2,997            | 100.00% | \$3,260        | 100.00% | \$(263) | (8.07 )% |

## Non-interest Expense

Total non-interest expense increased \$593,000 for the three months ended March 31, 2016 compared to the same period of 2015. The increase in salaries and employee benefits is primarily attributable to increases in health insurance. Furniture and equipment expenses increased primarily due to the construction and subsequent opening of a new branch in late 2015. Other expenses increased primarily due to increased expenses related to the debit card EMV (chip embedded card) conversion and system upgrades.

Non-interest expense composition for the three months ended March 31, 2016 and 2015 was as follows:

| (In Thousands)  | Three Months Ended |         |                |         |        |         |
|---|--------------------|---------|----------------|---------|--------|---------|
|   | March 31, 2016     |         | March 31, 2015 |         | Change |         |
|   | Amount             | % Total | Amount         | % Total | Amount | %       |
| Salaries and employee benefits                          | \$4,580            | 50.55 % | \$4,470        | 52.79 % | \$110  | 2.46 %  |
| Occupancy   | 541                | 5.97    | 628            | 7.42    | (87 )  | (13.85) |
| Furniture and equipment                                 | 701                | 7.74    | 595            | 7.03    | 106    | 17.82   |
| Pennsylvania shares tax                                 | 258                | 2.85    | 224            | 2.64    | 34     | 15.18   |
| Amortization of investment in limited partnerships      | 152                | 1.68    | 165            | 1.95    | (13 )  | (7.88 ) |
| Federal Deposit Insurance Corporation deposit insurance | 232                | 2.56    | 215            | 2.54    | 17     | 7.91    |
| Marketing   | 210                | 2.32    | 129            | 1.52    | 81     | 62.79   |
| Intangible amortization                                 | 87                 | 0.96    | 82             | 0.97    | 5      | 6.10    |
| Other   | 2,300              | 25.37   | 1,960          | 23.14   | 340    | 17.35   |
| Total non-interest expense                              | \$9,061            | 100.00% | \$8,468        | 100.00% | \$593  | 7.00 %  |

## Provision for Income Taxes

Income taxes decreased \$34,000 for the three months ended March 31, 2016 compared to the same periods of 2015. The primary cause of the increase in tax expense for the three months ended March 31, 2016 compared to 2015 is the impact of a reduction of \$292,000 in tax-exempt interest income within the investment portfolio. Excluding the impact of the net securities gains, the effective tax rate for the three months ended March 31, 2016 was 20.67% compared to 17.60% for the same period of 2015. The Company currently is in a deferred tax asset position due to the low income

housing tax credits earned both currently and previously. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

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## ASSET/LIABILITY MANAGEMENT

## Cash and Cash Equivalents

Cash and cash equivalents increased \$24,329,000 from \$22,796,000 at December 31, 2015 to \$47,125,000 at March 31, 2016 primarily as a result of the following activities during the three months ended March 31, 2016:

## Loans Held for Sale

Activity regarding loans held for sale resulted in originations trailing sales proceeds, less \$467,000 in realized gains, by \$243,000 for the three months ended March 31, 2016.

## Loans

Gross loans decreased \$3,955,000 since December 31, 2015 due to a decrease in commercial, financial, and agricultural loans.

The allocation of the loan portfolio, by category, as of March 31, 2016 and December 31, 2015 is presented below:

| (In Thousands)                          | March 31, 2016 |          | December 31, 2015 |          | Change     |         |
|---|----------------|----------|-------------------|----------|------------|---------|
|   | Amount         | % Total  | Amount            | % Total  | Amount     | %       |
| Commercial, financial, and agricultural | \$ 152,891     | 14.68 %  | \$ 164,072        | 15.70 %  | \$(11,181) | (6.81)% |
| Real estate mortgage:                   |                |          |                   |          |            |         |
| Residential                             | 531,424        | 51.05    | 526,183           | 50.34    | 5,241      | 1.00 %  |
| Commercial                              | 306,259        | 29.41    | 302,539           | 28.95    | 3,720      | 1.23 %  |
| Construction                            | 25,389         | 2.44     | 26,824            | 2.57     | (1,435)    | (5.35)% |
| Installment loans to individuals        | 26,702         | 2.56     | 27,001            | 2.58     | (299)      | (1.11)% |
| Net deferred loan fees and discounts    | (1,413)        | (0.14)   | (1,412)           | (0.14)   | (1)        | 0.07 %  |
| Gross loans                             | \$ 1,041,252   | 100.00 % | \$ 1,045,207      | 100.00 % | \$(3,955)  | (0.38)% |

The following table shows the amount of accrual and non-accrual TDRs at March 31, 2016 and December 31, 2015:

| (In Thousands)                          | March 31, 2016 |             |          | December 31, 2015 |             |          |
|---|----------------|-------------|----------|-------------------|-------------|----------|
|   | Accrual        | Non-accrual | Total    | Accrual           | Non-accrual | Total    |
| Commercial, financial, and agricultural | \$ 304         | \$ 145      | \$ 449   | \$ 320            | \$ 149      | \$ 469   |
| Real estate mortgage:                   |                |             |          |                   |             |          |
| Residential                             | 1,410          | 350         | 1,760    | 1,428             | 353         | 1,781    |
| Commercial                              | 5,031          | 2,263       | 7,294    | 5,085             | 2,312       | 7,397    |
|   | \$ 6,745       | \$ 2,758    | \$ 9,503 | \$ 6,833          | \$ 2,814    | \$ 9,647 |

## Investments

The fair value of the investment securities portfolio at March 31, 2016 decreased \$22,461,000 since December 31, 2015 while the amortized cost of the portfolio decreased \$24,081,000. The decrease in value is the result of the investment portfolio being actively managed in order to reduce interest rate and market risk. This is being undertaken



primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. The proceeds of the bond sales are being deployed into loans and intermediate term corporate bonds and short and intermediate term municipal bonds. The strategy to sell a portion of the long-term bond portfolio does negatively impact current earnings, but this action plays a key role in our long-term asset liability management strategy as the balance sheet is shortened to better prepare for a rising rate environment. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 89% of the debt securities portfolio on an amortized cost basis is currently rated A or higher by either S&P or Moody's.

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The Company considers various factors, which include examples from applicable accounting guidance, when analyzing the available for sale portfolio for possible other than temporary impairment. The Company primarily considers the following factors in its analysis: length of time and severity of the fair value being less than carrying value; reduction of dividend paid (equities); continued payment of dividend/interest, credit rating, and financial condition of an issuer; intent and ability to hold until anticipated recovery (which may be maturity); and general outlook for the economy, specific industry, and entity in question.

The bond portion of the portfolio review is conducted with emphases on several factors. Continued payment of principal and interest is given primary importance with credit rating and financial condition of the issuer following as the next most important. Credit ratings were reviewed with the ratings of the bonds being satisfactory. Bonds that were not currently rated were discussed with a third party and/or underwent an internal financial review. The Company also monitors whether each of the investments incurred a decline in fair value from carrying value of at least 20% for twelve consecutive months or a similar decline of at least 50% for three consecutive months. Each bond is reviewed to determine whether it is a general obligation bond, which is backed by the credit and taxing power of the issuing jurisdiction, or revenue bond, which is only payable from specified revenues. Based on the review undertaken by the Company, the Company determined that the decline in value of the various bond holdings were temporary and were the result of the general market downturns and interest rate/yield curve changes, not credit issues. The fact that almost all of such bonds are general obligation bonds further solidified the Company's determination that the decline in the value of these bond holdings is temporary.

The fair value of the equity portfolio continues to fluctuate as the economic turbulence continues to impact stock pricing. The amortized cost of the available for sale equity securities portfolio has decreased \$4,286,000 to \$11,325,000 at March 31, 2016 from \$15,611,000 at December 31, 2015 while the fair value decreased \$4,433,000 over the same time period.

The equity portion of the portfolio is reviewed for possible other than temporary impairment in a similar manner to the bond portfolio with greater emphasis placed on the length of time the fair value has been less than the carrying value and financial sector outlook. The Company also reviews dividend payment activities. The starting point for the equity analysis is the length and severity of a market price decline. The Company monitors two primary measures: 20% decline in fair value from carrying value for twelve consecutive months and 50% decline for three consecutive months.

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at March 31, 2016 follows:

| (In Thousands)                        | A- to AAA      |            | B- to BBB+     |            | Not Rated      |            | Total          |            |
|---------------------------------------|----------------|------------|----------------|------------|----------------|------------|----------------|------------|
|                                       | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Available for sale (AFS)              |                |            |                |            |                |            |                |            |
| U.S. Government and agency securities | \$3,474        | \$3,476    | \$—            | \$—        | \$—            | \$—        | \$3,474        | \$3,476    |
| Mortgage-backed securities            | 9,465          | 9,751      | —              | —          | —              | —          | 9,465          | 9,751      |
| Asset-backed securities               | 1,826          | 1,793      | —              | —          | —              | —          | 1,826          | 1,793      |
| State and political securities        | 65,810         | 67,811     | —              | —          | 2,723          | 2,764      | 68,533         | 70,575     |
| Other debt securities                 | 48,406         | 48,178     | 8,674          | 8,037      | —              | —          | 57,080         | 56,215     |
| Total debt securities AFS             | \$128,981      | \$131,009  | \$8,674        | \$8,037    | \$2,723        | \$2,764    | \$140,378      | \$141,810  |

## Financing Activities

## Deposits

Total deposits increased \$27,701,000 from December 31, 2015 to March 31, 2016. The growth was led by an increase in NOW deposit accounts from December 31, 2015 to March 31, 2016 of 8.00%. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios. The increase in deposits is the result of our focus on building relationships, not by offering market leading rates.

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Deposit balances and their changes for the periods being discussed follow:

| (In Thousands)        | March 31, 2016 |         | December 31, 2015 |         | Change     |         |
|-----------------------|----------------|---------|-------------------|---------|------------|---------|
|                       | Amount         | % Total | Amount            | % Total | Amount     | %       |
| Demand deposits       | \$269,362      | 25.42 % | \$280,083         | 27.15 % | \$(10,721) | (3.83)% |
| NOW accounts          | 190,168        | 17.95   | 176,078           | 17.06   | 14,090     | 8.00    |
| Money market deposits | 226,659        | 21.39   | 209,782           | 20.33   | 16,877     | 8.05    |
| Savings deposits      | 153,217        | 14.46   | 144,561           | 14.01   | 8,656      | 5.99    |
| Time deposits         | 220,175        | 20.78   | 221,376           | 21.45   | (1,201)    | (0.54)  |
|                       | \$1,059,581    | 100.00% | \$1,031,880       | 100.00% | \$27,701   | 2.68 %  |

**Borrowed Funds**

Total borrowed funds decreased 22.35% or \$30,764,000 to \$106,899,000 at March 31, 2016 compared to \$137,663,000 at December 31, 2015. Short-term and long-term borrowings primarily decreased due to growth in deposits.

| (In Thousands)                                | March 31, 2016 |         | December 31, 2015 |         | Change     |           |
|---|----------------|---------|-------------------|---------|------------|-----------|
|   | Amount         | % Total | Amount            | % Total | Amount     | %         |
| Short-term borrowings:                        |                |         |                   |         |            |           |
| FHLB repurchase agreements                    | \$—            | — %     | \$28,304          | 20.56 % | \$(28,304) | (100.00)% |
| Securities sold under agreement to repurchase | 15,874         | 14.85   | 18,334            | 13.32   | (2,460)    | (13.42)   |
| Total short-term borrowings                   | 15,874         | 14.85   | 46,638            | 33.88   | (30,764)   | (65.96)   |
| Long-term borrowings:                         |                |         |                   |         |            |           |
| Long-term FHLB borrowings                     | 90,625         | 84.78   | 90,625            | 65.83   | —          | —         |
| Long-term capital lease                       | 400            | 0.37    | 400               | 0.29    | —          | —         |
| Total long-term borrowings                    | 91,025         | 85.15   | 91,025            | 66.12   | —          | — %       |
| Total borrowed funds                          | \$106,899      | 100.00% | \$137,663         | 100.00% | \$(30,764) | (22.35) % |

**Capital**

The adequacy of the Company's capital is reviewed on an ongoing basis with reference to the size, composition, and quality of the Company's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings.

Bank holding companies are required to comply with the Federal Reserve Board's risk-based capital guidelines. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets. Specifically, each is required to maintain certain minimum dollar amounts and ratios of common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital. In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvements Act (FDICIA) established five capital categories ranging from "well capitalized" to "critically undercapitalized." To be classified as "well capitalized", common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital ratios must be at least 6.5%, 8%, 10%, and 5%, respectively.



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The Company's capital ratios as of March 31, 2016 and December 31, 2015 were as follows:

| (In Thousands)   | March 31, 2016 |        | December 31, 2015 |        |
|--|----------------|--------|-------------------|--------|
|  | Amount         | Ratio  | Amount            | Ratio  |
| Common Equity Tier I Capital (to Risk-weighted Assets) |                |        |                   |        |
| Actual   | \$121,772      | 11.26% | \$121,665         | 11.24% |
| For Capital Adequacy Purposes                          | 48,666         | 4.50   | 48,722            | 4.50   |
| To Be Well Capitalized                                 | 70,295         | 6.50   | 70,377            | 6.50   |
| Tier I Capital (to Risk-weighted Assets)               |                |        |                   |        |
| Actual   | \$121,772      | 11.26% | \$121,665         | 11.24% |
| For Capital Adequacy Purposes                          | 64,887         | 6.00   | 64,963            | 6.00   |
| To Be Well Capitalized                                 | 86,517         | 8.00   | 86,617            | 8.00   |
| Total Capital (to Risk-weighted Assets)                |                |        |                   |        |
| Actual   | \$126,199      | 11.67% | \$134,067         | 12.38% |
| For Capital Adequacy Purposes                          | 86,512         | 8.00   | 86,617            | 8.00   |
| To Be Well Capitalized                                 | 108,140        | 10.00  | 108,272           | 10.00  |
| Tier I Capital (to Average Assets)                     |                |        |                   |        |
| Actual   | \$121,772      | 9.40%  | \$121,665         | 9.38%  |
| For Capital Adequacy Purposes                          | 51,818         | 4.00   | 51,862            | 4.00   |
| To Be Well Capitalized                                 | 64,772         | 5.00   | 64,828            | 5.00   |

Jersey Shore State Bank's capital ratios as of March 31, 2016 and December 31, 2015 were as follows:

| (In Thousands)   | March 31, 2016 |        | December 31, 2015 |        |
|--|----------------|--------|-------------------|--------|
|  | Amount         | Ratio  | Amount            | Ratio  |
| Common Equity Tier I Capital (to Risk-weighted Assets) |                |        |                   |        |
| Actual   | \$83,113       | 10.79% | \$82,682          | 10.70% |
| For Capital Adequacy Purposes                          | 34,663         | 4.50   | 34,773            | 4.50   |
| To Be Well Capitalized                                 | 50,068         | 6.50   | 50,227            | 6.50   |
| Tier I Capital (to Risk-weighted Assets)               |                |        |                   |        |
| Actual   | \$83,113       | 10.79% | \$82,682          | 10.70% |
| For Capital Adequacy Purposes                          | 46,217         | 6.00   | 46,363            | 6.00   |
| To Be Well Capitalized                                 | 61,622         | 8.00   | 61,818            | 8.00   |
| Total Capital (to Risk-weighted Assets)                | -              |        |                   |        |
| Actual   | \$84,973       | 11.03% | \$92,036          | 11.91% |
| For Capital Adequacy Purposes                          | 61,630         | 8.00   | 61,818            | 8.00   |
| To Be Well Capitalized                                 | 77,038         | 10.00  | 77,272            | 10.00  |
| Tier I Capital (to Average Assets)                     |                |        |                   |        |
| Actual   | \$83,113       | 8.69%  | \$82,682          | 8.66%  |
| For Capital Adequacy Purposes                          | 38,269         | 4.00   | 38,175            | 4.00   |
| To Be Well Capitalized                                 | 47,836         | 5.00   | 47,719            | 5.00   |



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Luzerne Bank's capital ratios as of March 31, 2016 and December 31, 2015 were as follows:

| (In Thousands)   | March 31, 2016 |         | December 31, 2015 |         |
|--|----------------|---------|-------------------|---------|
|  | Amount         | Ratio   | Amount            | Ratio   |
| Common Equity Tier I Capital (to Risk-weighted Assets) |                |         |                   |         |
| Actual   | \$30,382       | 9.83 %  | \$30,549          | 10.66 % |
| For Capital Adequacy Purposes                          | 13,908         | 4.50    | 12,901            | 4.50    |
| To Be Well Capitalized                                 | 20,090         | 6.50    | 18,635            | 6.50    |
| Tier I Capital (to Risk-weighted Assets)               |                |         |                   |         |
| Actual   | \$30,382       | 9.80 %  | \$30,549          | 10.66 % |
| For Capital Adequacy Purposes                          | 18,601         | 6.00    | 17,201            | 6.00    |
| To Be Well Capitalized                                 | 24,802         | 8.00    | 22,935            | 8.00    |
| Total Capital (to Risk-weighted Assets)                |                |         |                   |         |
| Actual   | \$32,696       | 10.58 % | \$33,274          | 11.61 % |
| For Capital Adequacy Purposes                          | 24,723         | 8.00    | 22,935            | 8.00    |
| To Be Well Capitalized                                 | 30,904         | 10.00   | 28,669            | 10.00   |
| Tier I Capital (to Average Assets)                     |                |         |                   |         |
| Actual   | \$30,382       | 8.87 %  | \$30,549          | 8.90 %  |
| For Capital Adequacy Purposes                          | 13,701         | 4.00    | 13,725            | 4.00    |
| To Be Well Capitalized                                 | 17,126         | 5.00    | 17,157            | 5.00    |

In July 2013, the federal bank regulatory agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. The July 2013 final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered "well capitalized") and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered "well capitalized"); the total capital ratio remains at 8.0% under the new rules (10.0% to be considered "well capitalized"). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements were effective beginning on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016. The Company and the Banks will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Banks.

#### Liquidity; Interest Rate Sensitivity and Market Risk

The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future



outlook.

The following liquidity measures are monitored for compliance and were within the limits cited at March 31, 2016:

1. Net Loans to Total Assets, 85% maximum
2. Net Loans to Total Deposits, 100% maximum
3. Cumulative 90 day Maturity GAP %, +/- 20% maximum
4. Cumulative 1 Year Maturity GAP %, +/- 25% maximum

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Fundamental objectives of the Company's asset/liability management process are to maintain adequate liquidity while minimizing interest rate risk. The maintenance of adequate liquidity provides the Company with the ability to meet its financial obligations to depositors, loan customers, and shareholders. Additionally, it provides funds for normal operating expenditures and business opportunities as they arise. The objective of interest rate sensitivity management is to increase net interest income by managing interest sensitive assets and liabilities in such a way that they can be repriced in response to changes in market interest rates.

The Banks, like other financial institutions, must have sufficient funds available to meet liquidity needs for deposit withdrawals, loan commitments and originations, and expenses. In order to control cash flow, the Banks estimate future cash flows from deposits, loan payments, and investment security payments. The primary sources of funds are deposits, principal and interest payments on loans and investment securities, FHLB borrowings, and brokered deposits. Management believes the Banks have adequate resources to meet their normal funding requirements.

Management monitors the Company's liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale and trading investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core funding to satisfy depositor, borrower, and creditor needs.

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential, as well as the current cost of borrowing funds. The Company has a total current maximum borrowing capacity at the FHLB of \$521,413,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$35,366,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$90,625,000 as of March 31, 2016.

Interest rate sensitivity, which is closely related to liquidity management, is a function of the repricing characteristics of the Company's portfolio of assets and liabilities. Asset/liability management strives to match maturities and rates between loan and investment security assets with the deposit liabilities and borrowings that fund them. Successful asset/liability management results in a balance sheet structure which can cope effectively with market rate fluctuations. The matching process by segments both assets and liabilities into future time periods (usually 12 months, or less) based upon when repricing can be effected. Repriceable assets are subtracted from repriceable liabilities, for a specific time period to determine the "gap", or difference. Once known, the gap is managed based on predictions about future market interest rates. Intentional mismatching, or gapping, can enhance net interest income if market rates move as predicted. However, if market rates behave in a manner contrary to predictions, net interest income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to determine the effects of interest rate movements on shareholders' equity and a simulation analysis to monitor the effects of interest rate changes on the Company's balance sheet.

The Company currently maintains a GAP position of being asset sensitive. The Company has strategically taken this position as it has decreased the duration of the earning asset portfolio by adding quality short and intermediate term loans such as home equity loans and the selling of long-term municipal bonds. Lengthening of the liability portfolio is being undertaken to build protection in a rising rate environment.

A market value at risk calculation is utilized to monitor the effects of interest rate changes on the Company's balance sheet and more specifically shareholders' equity. The Company does not manage the balance sheet structure in order

to maintain compliance with this calculation. The calculation serves as a guideline with greater emphases placed on interest rate sensitivity. Changes to calculation results from period to period are reviewed as changes in results could be a signal of future events. As of the most recent analysis, the results of the market value at risk calculation were within established guidelines due to the strategic direction being taken.

#### Interest Rate Sensitivity

In this analysis the Company examines the result of a 100, 200, 300, and 400 basis point change in market interest rates and the effect on net interest income. It is assumed that the change is instantaneous and that all rates move in a parallel manner. Assumptions are also made concerning prepayment speeds on mortgage loans and mortgage securities.

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The following is a rate shock forecast for the twelve month period ending March 31, 2017 assuming a static balance sheet as of March 31, 2016.

| (In Thousands)             | Parallel Rate Shock in Basis Points |          |          |          |          |          |          |
|----------------------------|-------------------------------------|----------|----------|----------|----------|----------|----------|
|                            | -200                                | -100     | Static   | +100     | +200     | +300     | +400     |
| Net interest income        | \$34,892                            | \$37,519 | \$40,386 | \$42,847 | \$45,222 | \$47,249 | \$48,789 |
| Change from static         | (5,494 )                            | (2,867 ) | —        | 2,461    | 4,836    | 6,863    | 8,403    |
| Percent change from static | -13.60 %                            | -7.10 %  | —        | 6.09 %   | 11.97 %  | 16.99 %  | 20.81 %  |

The model utilized to create the report presented above makes various estimates at each level of interest rate change regarding cash flow from principal repayment on loans and mortgage-backed securities and/or call activity on investment securities. Actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change. In addition, the limits stated above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

**Inflation**

The asset and liability structure of a financial institution is primarily monetary in nature. Therefore, interest rates rather than inflation have a more significant impact on the Company's performance. Interest rates are not always affected in the same direction or magnitude as prices of other goods and services, but are reflective of fiscal policy initiatives or economic factors which are not measured by a price index.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at both the level of the Company and the Banks. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's gap analysis or simulation analysis compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2015. Additional information and details are provided in the "Liquidity, Interest Rate Sensitivity, and Market Risk" section of "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Generally, management believes the Company is well positioned to respond in a timely manner when the market interest rate outlook changes.

**Item 4. Controls and Procedures****Evaluation of Disclosure Controls and Procedures**

An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of March 31, 2016.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2016, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## Part II. OTHER INFORMATION

## Item 1. Legal Proceedings

None.

## Item 1A. Risk Factors

There are no material changes to the risk factors set forth in Part I, Item 1A, "Risk Factors," of the Company's Annual Report on Form 10-K for the year ended December 31, 2015. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides certain information with respect to the Company's repurchase of common stock during the quarter ended March 31, 2016.

| Period                                    | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Units) Purchased | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| Month #1 (January 1 - January 31, 2016)   | —   | \$  | —   | 404,744   |
| Month #2 (February 1 - February 29, 2016) | 9,363                                       | 39.56   | 9,363   | 395,381   |
| Month #3 (March 1 - March 31, 2016)       | 5,237                                       | 38.91   | 5,237   | 390,144   |

On April 25, 2016, the Board of Directors extended the previously approved authorization to repurchase up to 482,000 shares, or approximately 10%, of the outstanding shares of the Company for an additional year to April 30, 2017. As of March 31, 2016 there have been 91,856 shares repurchased under this plan.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.



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Item 6.

Exhibits

- 3(i) Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Quarterly Report on Form 10-Q for the period ended March 31, 2012).
  - 3(ii) Bylaws of the Registrant (incorporated by reference to Exhibit 3(ii) of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011).
  - 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer.
  - 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer.
  - 32(i) Section 1350 Certification of Chief Executive Officer.
  - 32(ii) Section 1350 Certification of Chief Financial Officer.
- 101 Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at March 31, 2016 and December 31, 2015; (ii) the Consolidated Statement of Income for the three months ended March 31, 2016 and 2015; (iii) Consolidated Statement of Comprehensive Income for the three months ended March 31, 2016 and 2015; (iv) the Consolidated Statement of Shareholders' Equity for the three months ended March 31, 2016 and 2015; (v) the Consolidated Statement of Cash Flows for the three months ended March 31, 2016 and 2015; and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.



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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PENNS WOODS BANCORP, INC.  
(Registrant)

Date: May 10, 2016 /s/ Richard A. Grafmyre  
Richard A. Grafmyre, President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 10, 2016 /s/ Brian L. Knepp  
Brian L. Knepp, Senior Vice President and Chief Financial Officer  
(Principal Financial Officer and Principal Accounting  
Officer)

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EXHIBIT INDEX

Exhibit 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer

Exhibit 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer

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