CITIZENS FINANCIAL SERVICES INC
Form 10-K
March 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2015

or

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

For the transition period from to

Commission file number 000-13222

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

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

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

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $1.00 per share
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions 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

Non-accelerated filer o Smaller reporting company o

(Do not check if a smaller reporting company)

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. $131,083,374 as of June 30, 2015.

As of February 23, 2016, there were 3,335,876 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Part III is incorporated by reference to the Registrant's Definitive Proxy Statement for the 2016 Annual Meeting of Shareholders.

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PART I

ITEM 1 – BUSINESS.

CITIZENS FINANCIAL SERVICES, INC.

Citizens Financial Services, Inc. (the "Company"), a Pennsylvania corporation, was incorporated on April 30, 1984 to be the holding company for First Citizens Community Bank (the "Bank"), which until 2012, and in connection with its conversion from a national bank to a Pennsylvania-chartered bank and trust company, operated under the name First Citizens National Bank. The Company is primarily engaged in the ownership and management of the Bank and the Bank's wholly-owned insurance agency subsidiary, First Citizens Insurance Agency, Inc. On December 11, 2015, the Company completed the acquisition of The First National Bank of Fredericksburg ("FNB") by merging FNB into the Bank, with the Bank as the resulting institution.

AVAILABLE INFORMATION

A copy of the Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current events reports on Form 8-K, and amendments to these reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge through the Company's web site at www.firstcitizensbank.com as soon as reasonably practicable after such reports are filed with or furnished to the Securities and Exchange Commission. Information on our website shall not be considered as incorporated by reference into this Form 10-K.

FIRST CITIZENS COMMUNITY BANK

The Bank is a full-service bank engaged in a broad range of banking activities and services for individual, business, governmental and institutional customers. These activities and services principally include checking, savings, and time deposit accounts; residential, commercial and agricultural real estate, commercial and industrial, state and political subdivision and consumer loans; and a variety of other specialized financial services. The Trust and Investment division of the Bank offers a full range of client investment, estate, mineral management and retirement services.

The Bank's main office is located at 15 South Main Street, Mansfield, (Tioga County) Pennsylvania. The Bank's primary market area consists of the Pennsylvania Counties of Bradford, Clinton, Potter and Tioga in north central Pennsylvania. It also includes Allegany, Steuben, Chemung and Tioga Counties in Southern New York. With the completion of the FNB acquisition, the Bank has added seven additional banking offices in south central Pennsylvania; four offices in Lebanon Country, two offices in Schuylkill County, and one office in Berks County. The economy of the Bank's market areas are diversified and include manufacturing industries, wholesale and retail trade, service industries, agricultural and the production of natural resources of gas and timber. We are dependent geographically upon the economic conditions in both north central and south central Pennsylvania, as well as the southern tier of New York. In addition to the main office in Mansfield and the additional seven offices acquired from FNB, the Bank has 16 other full service branch offices in its market areas.

As of December 31, 2015, the Bank had 229 full time employees and 51 part-time employees, resulting in 246 full time equivalent employees at our corporate offices and other banking locations.

COMPETITION

The banking industry in the Bank's service area is intensely competitive, both among commercial banks and with financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions, mortgage banking firms, financial companies, financial affiliates of industrial companies, internet entities, and government sponsored agencies, such as Freddie Mac and Fannie Mae, provide additional competition for loans and other financial services. The overall economy, which continues to be sluggish, has also increased competitive pressures particularly for entities seeking loan growth. Additionally, north central Pennsylvania has benefited from additional wealth resulting from the exploration for natural gas in our primary market. This has resulted in increased competition from brokerage firms and retirement fund management firms. The Bank is generally competitive with all competing financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

Additional information related to our business and competition is included in Part II, Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations”.

SUPERVISION AND REGULATION

GENERAL

The Bank is subject to extensive regulation, examination and supervision by the Pennsylvania Department of Banking (“PDB”) and, as a member of the Federal Reserve System, by the Board of Governors of the Federal Reserve System (the “FRB”). Federal and state banking laws and regulations govern, among other things, the scope of a bank’s business, the investments a bank may make, the reserves against deposits a bank must maintain, terms of deposit accounts, loans a bank makes, the interest rates a bank charges and collateral a bank takes, the activities of a bank with respect to mergers and consolidations and the establishment of branches. The Company is registered as a bank holding company and is subject to supervision and regulation by FRB under the Bank Holding Company Act of 1956, as amended (the “BHCA”).

PENNSYLVANIA BANKING LAWS

The Pennsylvania Banking Code (“Banking Code”) contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PDB so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices.

Pennsylvania law also provides Pennsylvania state chartered institutions elective parity with the power of national banks, federal thrifts, and state-chartered institutions in other states as authorized by the FDIC, subject to a required notice to the PDB. The Federal Deposit Insurance Corporation Act (“FDIA”), however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless (1) the FDIC determines the activity or investment does not pose a significant risk of loss to the Deposit Insurance Fund and (2) the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is restricted by the FDIA.

In April 2008, banking regulators in the States of New Jersey, New York, and Pennsylvania entered into a Memorandum of Understanding (the “Interstate MOU”) to clarify their respective roles, as home and host state regulators, regarding interstate branching activity on a regional basis pursuant to the Riegle-Neal Amendments Act of 1997. The Interstate MOU establishes the regulatory responsibilities of the respective state banking regulators regarding bank regulatory examinations and is intended to reduce the regulatory burden on state chartered banks branching within the region by eliminating duplicative host state compliance exams. Under the Interstate MOU, the activities of branches we established in New York would be governed by Pennsylvania state law to the same extent that federal law governs the activities of the branch of an out-of-state national bank in such host states. Issues regarding whether a particular host state law is preempted are to be determined in the first instance by the PDB. In the event that the PDB and the applicable host state regulator disagree regarding whether a particular host state law is pre-empted, the PDB and the applicable host state regulator would use their reasonable best efforts to consider all points of view and to resolve the disagreement.

COMMUNITY REINVESTMENT ACT

The Community Reinvestment Act, (“CRA”), as implemented by FRB regulations, provides that the Bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its

entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the FRB, in connection with its examination of the Bank, to assess the institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain corporate applications by such institution, such as mergers and branching. The Bank's most recent rating was "Satisfactory." Various consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the FRB as it attempts to control the money supply and credit availability in order to influence the economy.

THE DODD-FRANK ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") has significantly changed the current bank regulatory structure and will affect it into the immediate future the lending and investment activities and general operations of depository institutions and their holding companies.

The Dodd-Frank Act requires the FRB to establish minimum consolidated capital requirements for bank holding companies that are as stringent as those required for insured depository institutions; the components of Tier 1 capital would be restricted to capital instruments that are currently considered to be Tier 1 capital for insured depository institutions. In addition, the proceeds of trust preferred securities are excluded from Tier 1 capital unless (i) such securities are issued by bank holding companies with assets of less than $500 million or (ii) such securities were issued prior to May 19, 2010 by bank or savings and loan holding companies with less than $15 billion of assets. The exclusion of such proceeds are phased in over a three year period beginning in 2013.

The Dodd-Frank Act also created a new Consumer Financial Protection Bureau with extensive powers to implement and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rulemaking authority for a wide range of consumer protection laws that apply to all banks, among other things, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. However, institutions of less than $10 billion in assets, such as the Bank, will continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their prudential regulators.

The Dodd-Frank Act created a new supervisory structure for oversight of the U.S. financial system, including the establishment of a new council of regulators, the Financial Stability Oversight Council, to monitor and address systemic risks to the financial system. Non-bank financial companies that are deemed to be significant to the stability of the U.S. financial system and all bank holding companies with $50 billion or more in total consolidated assets will be subject to heightened supervision and regulation. The FRB will implement prudential requirements and prompt corrective action procedures for such companies.

The Dodd-Frank Act made many other changes in banking regulation. Those include allowing depository institutions, for the first time, to pay interest on business checking accounts, requiring originators of securitized loans to retain a percentage of the risk for transferred loans, establishing regulatory rate-setting for certain debit card interchange fees and establishing a number of reforms for mortgage originations. Effective October 1, 2011, the debit-card interchange fee was capped at $0.21 per transaction, plus an additional 5 basis point charge to cover fraud losses. These fees are much lower than the current market rates. Although the regulation only impacts banks with assets above $10 billion, we believe that the provisions could result in a reduction in interchange revenue in the future.

The Dodd-Frank Act also broadened the base for FDIC insurance assessments. The FDIC was required to promulgate rules revising its assessment system so that it is based on the average consolidated total assets less tangible equity capital of an insured institution instead of deposits. That rule took effect April 1, 2011. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008.

Under provisions of the Dodd-Frank Act referred to as the "Volcker Rule" certain limitations are placed on the ability of bank holding companies and their affiliates to engage in sponsoring, investing in and transacting with certain investment funds, including hedge funds and private equity funds (collectively "covered funds"). The Volcker Rule also places restrictions on proprietary trading, which could impact certain hedging activities. The Volcker Rule became fully effective in July 2015. We do not expect this rule to have a material impact on the Company.

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The Dodd-Frank Act requires various federal agencies to promulgate numerous and extensive implementing regulations. Although the substance and scope of many of these regulations cannot be determined at this time, particularly those provisions relating to the new Consumer Financial Protection Bureau, the Dodd-Frank Act and implementing regulations may have a material impact on operations through, among other things, increased compliance costs, heightened regulatory supervision, and higher interest expense.

CURRENT CAPITAL REQUIREMENTS

Federal regulations require FDIC-insured depository institutions, including state-chartered, FRB-member banks, to meet several minimum capital standards. These capital standards were effective January 1, 2015, and result from a final rule implementing regulatory amendments based on recommendations of the Basel Committee on Banking Supervision and certain requirements of the Dodd-Frank Act.

The capital standards require the maintenance of common equity Tier 1 capital, Tier 1 capital and total capital to risk-weighted assets of at least 4.5%, 6.0% and 8.0%, respectively, and a leverage ratio of at least 4% of Tier 1 capital. Common equity Tier 1 capital is generally defined as common stockholders' equity and retained earnings. Tier 1 capital is generally defined as common equity Tier 1 and Additional Tier 1 capital. Additional Tier 1 capital generally includes certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries. Total capital includes Tier 1 capital (common equity Tier 1 capital plus Additional Tier 1 capital) and Tier 2 capital. Tier 2 capital is comprised of capital instruments and related surplus meeting specified requirements, and may include cumulative preferred stock and long-term perpetual preferred stock, mandatory convertible securities, intermediate preferred stock and subordinated debt. Also included in Tier 2 capital is the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and, for institutions that have exercised an opt-out election regarding the treatment of Accumulated Other Comprehensive Income ("AOCI"), up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. The Company has exercised the AOCI opt-out option and therefore AOCI is not incorporated into common equity Tier 1 capital. Calculation of all types of regulatory capital is subject to deductions and adjustments specified in the regulations.

In determining the amount of risk-weighted assets for purposes of calculating risk-based capital ratios, assets, including certain off-balance sheet assets (e.g., recourse obligations, direct credit substitutes, residual interests) are multiplied by a risk weight factor assigned by the regulations based on the risks believed inherent in the type of asset. Higher levels of capital are required for asset categories believed to present greater risk. For example, a risk weight of 0% is assigned to cash and U.S. government securities, a risk weight of 50% is generally assigned to prudently underwritten first lien one- to four-family residential mortgages, a risk weight of 100% is assigned to commercial and consumer loans, a risk weight of 150% is assigned to certain past due loans and a risk weight of between 0% to 600% is assigned to permissible equity interests, depending on certain specified factors.

In addition to establishing the minimum regulatory capital requirements, the regulations limit capital distributions by the institution and certain discretionary bonus payments to management if an institution does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets above the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement is being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented at 2.5% on January 1, 2019.

The FRB has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution's capital level is or may become inadequate in light of the particular risks or circumstances.

As of December 31, 2015, we met all applicable capital adequacy requirements.

PROMPT CORRECTIVE ACTION RULES

Federal law establishes a system of prompt corrective action to resolve the problems of undercapitalized institutions. The law requires that certain supervisory actions be taken against undercapitalized institutions, the severity of which depends on the degree of undercapitalization. The FRB has adopted regulations to implement the prompt corrective action legislation as to state member banks. The regulations were amended to incorporate the previously mentioned increased regulatory capital standards that were effective January 1, 2015. An institution is deemed to be “well capitalized” if it has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, a leverage ratio of 5.0% or greater and a common equity Tier 1 ratio of 6.5% or greater. An institution is “adequately capitalized” if it has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, a leverage ratio of 4.0% or greater and a common equity Tier 1 ratio of 4.5% or greater. An institution is “undercapitalized” if it has a total risk-based capital ratio of less than 8.0%, a Tier 1 risk-based capital ratio of less than 6.0%, a leverage ratio of less than 4.0% or a common equity Tier 1 ratio of less than 4.5%. An institution is deemed to be “significantly undercapitalized” if it has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 4.0%, a leverage ratio of less than 3.0% or a common equity Tier 1 ratio of less than 3.0%. An institution is considered to be “critically undercapitalized” if it has a ratio of tangible equity (as defined in the regulations) to total assets that is equal to or less than 2.0%.

Subject to a narrow exception, a receiver or conservator must be appointed for an institution that is “critically undercapitalized” within specified time frames. The regulations also provide that a capital restoration plan must be filed with the FRB within 45 days of the date an institution is deemed to have received notice that it is “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized.” Compliance with the capital restoration plan must be guaranteed by any parent holding company up to the lesser of 5% of the depository institution’s total assets when it was deemed to be undercapitalized or the amount necessary to achieve compliance with applicable capital requirements. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The FRB could also take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors. Significantly and critically undercapitalized institutions are subject to additional mandatory and discretionary measures.

STANDARDS FOR SAFETY AND SOUNDNESS

The federal banking agencies have adopted Interagency Guidelines prescribing Standards for Safety and Soundness in various areas such as internal controls and information systems, internal audit, loan documentation and credit underwriting, interest rate exposure, asset growth and quality, earnings and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the FRB determines that a state member bank fails to meet any standard prescribed by the guidelines, the FRB may require the institution to submit an acceptable plan to achieve compliance with the standard.

ENFORCEMENT

The PDB maintains enforcement authority over the Bank, including the power to issue cease and desist orders and civil money penalties and remove directors, officers or employees. The PDB also has the power to appoint a conservator or receiver for a bank upon insolvency, imminent insolvency, unsafe or unsound condition or certain other situations. The FRB has primary federal enforcement responsibility over FRB-member state banks and has authority to bring actions against the institution and all institution-affiliated parties, including shareholders, who knowingly or recklessly participate in wrongful actions likely to have an adverse effect on the bank. Formal enforcement action may range from the issuance of a capital directive or a cease and desist order, to removal of officers and/or directors. Civil penalties cover a wide range of violations and can amount to $25,000 per day, or even $1 million per day in especially egregious cases. The FDIC, as deposit insurer, has the authority to recommend to the FRB that enforcement action be taken with respect to a member bank. If the FRB does not take action, the FDIC has authority to take such action under certain circumstances. In general, regulatory enforcement actions occur with respect to situations involving unsafe or unsound practices or conditions, violations of law or regulation or breaches of fiduciary duty. Federal and Pennsylvania law also establish criminal penalties for certain violations.

REGULATORY RESTRICTIONS ON BANK DIVIDENDS

The Bank may not declare a dividend without approval of the FRB, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two years, less any required transfers to surplus.

Under Pennsylvania law, the Bank may only declare and pay dividends from its accumulated net earnings. In addition, the Bank may not declare and pay dividends from the surplus funds that Pennsylvania law requires that it maintain. Under these policies and subject to the restrictions applicable to the Bank, the Bank could have declared, during 2015, without prior regulatory approval, aggregate dividends of approximately $9.2 million, plus net profits earned to the date of such dividend declaration.

BANK SECRECY ACT

Under the Bank Secrecy Act (BSA), banks and other financial institutions are required to retain records to assure that the details of financial transactions can be traced if investigators need to do so. Banks are also required to report most cash transactions in amounts exceeding $10,000 made by or on behalf of their customers. Failure to meet BSA requirements may expose the Bank to statutory penalties, and a negative compliance record may affect the willingness of regulating authorities to approve certain actions by the Bank requiring regulatory approval, including new branches.

INSURANCE OF DEPOSIT ACCOUNTS

The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC. Under the FDIC's risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned, and certain adjustments specified by FDIC regulations. Until recently, assessment rates ranged from seven to 77.5 basis points of assessable deposits.

As required by the Dodd-Frank Act, the FDIC has issued final rules implementing changes to the assessment rules. The rules change the assessment base used for calculating deposit insurance assessments from deposits to total assets less tangible (Tier 1) capital. Since the new base is larger than the previous base, the FDIC also lowered assessment rates so that the rule would not significantly alter the total amount of revenue collected from the industry. The range of adjusted assessment rates is now 2.5 to 45 basis points of the new assessment base. The rule is expected to benefit smaller financial institutions, which typically rely more on deposits for funding, and shift more of the burden for supporting the insurance fund to larger institutions, which are thought to have greater access to nondeposit funding. No institution may pay a dividend if it is in default of its assessments. As a result of the Dodd-Frank Act, deposit insurance per account owner is $250,000 for all types of accounts.

The Dodd-Frank Act increased the minimum target DIF ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The FDIC must seek to achieve the 1.35% ratio by September 30, 2020. Insured institutions with assets of $10 billion or more are supposed to fund the increase. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the FDIC. The FDIC has recently exercised that discretion by establishing a long range fund ratio of 2%.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or regulatory condition imposed in writing. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

FEDERAL RESERVE SYSTEM

Under FRB regulations, the Bank is required to maintain reserves against its transaction accounts (primarily NOW and regular checking accounts). For 2016, the Bank is required to maintain average daily reserves equal to 3% on aggregate transaction accounts of up to $110.0 million, plus 10% on the remainder, and the first $15.2 million of otherwise reservable balances will be exempt. These reserve requirements are subject to annual adjustment by the FRB. The Bank is in compliance with the foregoing requirements.

ACQUISITION OF THE HOLDING COMPANY

Under the Federal Change in Bank Control Act (the “CIBCA”), a notice must be submitted to the FRB if any person (including a company), or group acting in concert, seeks to acquire 10% or more of the Company’s shares of outstanding common stock, unless the FRB has found that the acquisition will not result in a change in control of the Company. Under the CIBCA, the FRB generally has 60 days within which to act on such notices, taking into consideration certain factors, including the financial and managerial resources of the acquirer, the convenience and needs of the communities served by the Company and the Bank, and the anti-trust effects of the acquisition. Under the BHCA, any company would be required to obtain prior approval from the FRB before it may obtain “control” of the Company within the meaning of the BHCA. Control generally is defined to mean the ownership or power to vote 25% or more of any class of voting securities of the Company or the ability to control in any manner the election of a majority of the Company’s directors. An existing bank holding company would be required to obtain the FRB’s prior approval under the BHCA before acquiring more than 5% of the Company’s voting stock.

HOLDING COMPANY REGULATION

The Company, as a bank holding company, is subject to examination, supervision, regulation, and periodic reporting under the BHCA, as administered by the FRB. The Company is required to obtain the prior approval of the FRB to acquire all, or substantially all, of the assets of any bank or bank holding company. Prior FRB approval would be required for the Company to acquire direct or indirect ownership or control of any voting securities of any bank or bank holding company if it would, directly or indirectly, own or control more than 5% of any class of voting shares of the bank or bank holding company.

A bank holding company is generally prohibited from engaging in, or acquiring, direct or indirect control of more than 5% of the voting securities of any company engaged in nonbanking activities. One of the principal exceptions to this prohibition is for activities found by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Some of the principal activities that the FRB has determined by regulation to be closely related to banking are: (i) making or servicing loans; (ii) performing certain data processing services; (iii) providing securities brokerage services; (iv) acting as fiduciary, investment or financial advisor; (v) leasing personal or real property under certain conditions; (vi) making investments in corporations or projects designed primarily to promote community welfare; and (vii) acquiring a savings association.

A bank holding company that meets specified conditions, including that its depository institutions subsidiaries are “well capitalized” and “well managed,” can opt to become a “financial holding company.” A “financial holding company” may engage in a broader array of financial activities than permitted a typical bank holding company. Such activities can include insurance underwriting and investment banking. The Company does not anticipate opting for “financial holding company” status at this time.

The Company is subject to the FRB’s consolidated capital adequacy guidelines for bank holding companies. Traditionally, those guidelines have been structured similarly to the regulatory capital requirements for the subsidiary depository institutions, but were somewhat more lenient. For example, the holding company capital requirements allowed inclusion of certain instruments in Tier 1 capital that are not includable at the institution level. As previously noted, the Dodd-Frank Act requires that the guidelines be amended so that they are at least as stringent as those required for the subsidiary depository institutions. See “—The Dodd-Frank Act.”

A bank holding company is generally required to give the FRB prior written notice of any purchase or redemption of then outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the Company’s consolidated net worth. The FRB may disapprove such a purchase or redemption if it determines

that the proposal would constitute an unsafe and unsound practice, or would violate any law, regulation, FRB order or directive, or any condition imposed by, or written agreement with, the FRB. The FRB has adopted an exception to that approval requirement for well-capitalized bank holding companies that meet certain other conditions.

The FRB has issued a policy statement regarding the payment of dividends by bank holding companies. In general, the FRB's policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the bank holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. The FRB's policies also require that a bank holding company serve as a source of financial strength to its subsidiary banks by using available resources to provide capital funds during periods of financial stress or adversity and by maintaining the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks where necessary. The Dodd-Frank Act codified the source of strength policy and requires the promulgation of implementing regulations. Under the prompt corrective action laws, the ability of a bank holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. These regulatory policies could affect the ability of the Company to pay dividends or otherwise engage in capital distributions.

The Federal Deposit Insurance Act makes depository institutions liable to the Federal Deposit Insurance Corporation for losses suffered or anticipated by the insurance fund in connection with the default of a commonly controlled depository institution or any assistance provided by the Federal Deposit Insurance Corporation to such an institution in danger of default. That law would have potential applicability if the Company ever held as a separate subsidiary a depository institution in addition to the Bank.

The status of the Company as a registered bank holding company under the Bank Holding Company Act will not exempt it from certain federal and state laws and regulations applicable to corporations generally, including, without limitation, certain provisions of the federal securities laws.

EFFECT OF GOVERNMENT MONETARY POLICIES

The earnings and growth of the banking industry are affected by the credit policies of monetary authorities, including the Federal Reserve System. An important function of the Federal Reserve System is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open market activities in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These operations are used in varying combinations to influence overall economic growth and indirectly, bank loans, securities, and deposits. These variables may also affect interest rates charged on loans or paid on deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future.

In view of the changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities including the Federal Reserve System, no prediction can be made as to possible changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and the Bank. Additional information is included under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing in this Annual Report on Form 10-K.

ITEM 1A – RISK FACTORS.

Changing interest rates may decrease our earnings and asset values.

Our net interest income is the interest we earn on loans and investments less the interest we pay on our deposits and borrowings. Our net interest margin is the difference between the yield we earn on our assets and the interest rate we pay for deposits and our other sources of funding. Changes in interest rates—up or down—could adversely affect our net interest margin and, as a result, our net interest income. Although the yield we earn on our assets and our funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, causing our net interest margin to expand or contract. Our liabilities tend to be shorter in duration than our assets, so they may adjust faster in response to changes in interest rates. As a result, when interest rates rise, our funding costs may rise faster than the yield we earn on our assets, causing our net interest margin to contract until the asset yields catch up. Changes in the slope of the “yield curve”—or the spread between short-term and long-term interest rates—could also reduce our net interest margin. Normally, the yield curve is upward sloping, meaning short-term rates are lower than long-term rates. Because our liabilities tend to be shorter in duration than our assets, when the yield curve flattens or even inverts, we could experience pressure on our net interest margin as our cost of funds increases relative to the yield we can earn on our assets.

Changes in interest rates also affect the value of the Bank's interest-earning assets, and in particular the Bank's securities portfolio. Generally, the value of fixed-rate securities fluctuates inversely with changes in interest rates. Unrealized gains and losses on securities available for sale are reported as a separate component of shareholder equity, net of tax. Decreases in the fair value of securities available for sale resulting from increases in interest rates could have an adverse effect on shareholders' equity.

Local economic conditions are impacted by the exploration and drilling activities for natural gas in the in the Marcellus and Utica Shale formations.

Our market area is predominately centered in the Marcellus and Utica Shale natural gas exploration and drilling area, and as a result, the economy in north central Pennsylvania has become increasingly influenced by the natural gas industry. Loan demand, deposit levels and the market value of local real estate have been impacted by this activity. While the Company does not lend to the various entities directly engaged in exploration, drilling or production activities, many of our customers provide transportation and other services and products that support natural gas exploration and production activities. Therefore, our customers could be negatively impacted by the market price for natural gas as a significant downturn in this industry could impact the ability of our borrowers to repay their loans in accordance with their terms. Additionally, exploration and drilling activities may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection. Regulatory and market pricing of natural gas could also impact and/or reduce demand for loans and deposit levels. These factors could have a material adverse effect on our business, prospects, financial condition and results of operations.

Higher loan losses could require us to increase our allowance for loan losses through a charge to earnings.

When we loan money we incur the risk that our borrowers do not repay their loans. We reserve for loan losses by establishing an allowance through a charge to earnings. The amount of this allowance is based on our assessment of loan losses inherent in our loan portfolio. The process for determining the amount of the allowance is critical to our financial results and condition. It requires subjective and complex judgments about the future, including forecasts of economic or market conditions that might impair the ability of our borrowers to repay their loans. We might underestimate the loan losses inherent in our loan portfolio and have loan losses in excess of the amount reserved. We might increase the allowance because of changing economic conditions. For example, in a rising interest rate environment, borrowers with adjustable-rate loans could see their payments increase. There may be a significant increase in the number of borrowers who are unable or unwilling to repay their loans, resulting in our charging off more loans and increasing our allowance. In addition, when real estate values decline, the potential severity of loss on a real estate-secured loan can increase significantly, especially in the case of loans with high combined loan-to-value ratios. A decline in the national economy and the local economies of the areas in which the loans are concentrated could result in an increase in loan delinquencies, foreclosures or repossessions resulting in increased charge-off amounts and the need for additional loan loss allowances in future periods. In addition, bank regulators may require us to make a provision for loan losses or otherwise recognize further loan charge-offs following their periodic review of our loan portfolio, our underwriting procedures, and our loan loss allowance. Any increase in our allowance for loan losses or loan charge-offs as required by such regulatory authorities could have a material adverse effect on our financial condition and results of operations.

Our allowance for loan losses amounted to $7.1 million, or 1.02% of total loans outstanding and 99.3% of nonperforming loans, at December 31, 2015. Our allowance for loan losses at December 31, 2015 may not be sufficient to cover future loan losses. A large loss could deplete the allowance and require increased provisions to replenish the allowance, which would decrease our earnings. In addition, at December 31, 2015, we had a total of 29 loan relationships with outstanding balances that exceeded $3.0 million, 28 of which were performing according to their original terms. However, the deterioration of one or more of these loans could result in a significant increase in

our nonperforming loans and our provision for loan losses, which would negatively impact our results of operations.

Our emphasis on commercial real estate, agricultural, construction and municipal lending may expose us to increased lending risks.

At December 31, 2015, we had $237.5 million in loans secured by commercial real estate, $57.8 million in agricultural loans, $15.0 million in construction loans and $98.5 million in municipal loans. Commercial real estate loans, agricultural, construction and municipal loans represented 34.2%, 8.3%, 2.2% and 14.1%, respectively, of our loan portfolio. At December 31, 2015, we had $4.4 million of reserves specifically allocated to these loan types. While commercial real estate, agricultural, construction and municipal loans are generally more interest rate sensitive and carry higher yields than do residential mortgage loans, these types of loans generally expose a lender to greater risk of non-payment and loss than single-family residential mortgage loans because repayment of the loans often depends on the successful operation of the property, the income stream of the borrowers and, for construction loans, the accuracy of the estimate of the property's value at completion of construction and the estimated cost of construction. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to single-family residential mortgage loans.

Loan participations have been a significant source of loan originations in recent periods and a decline in loan participation volume could hurt profits and slow loan growth.

We have actively engaged in loan participations in recent periods whereby we are invited to participate in loans, primarily commercial real estate and municipal loans, originated by another financial institution known as the lead lender. We have participated with other financial institutions in both our primary markets and out of market areas. Loan participations accounted for approximately $14.3 million, $14.4 million and $13.1 million, or 37.6%, 100% and 50.4% of the Company's net organic loan growth during 2013, 2014 and 2015, respectively. Our profits and loan growth could be significantly and adversely affected if the volume of loan participations would materially decrease, whether because loan demand declines, loan payoffs, lead lenders may come to perceive us as a potential competitor in their respective market areas, or otherwise.

If we conclude that the decline in value of any of our investment securities is other than temporary, we are required to write down the value of that security through a charge to earnings.

We review our investment securities portfolio monthly and at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of our investment securities has declined below its carrying value, we are required to assess whether the decline is other than temporary. If we conclude that the decline is other than temporary, we are required to write down the value of that security through a charge to earnings. As of December 31, 2015, our investment portfolio included available for sale investment securities with an amortized cost of $356.4 million and a fair value of $359.7 million, which included unrealized losses on 91 securities totaling $801,000. Changes in the expected cash flows of these securities and/or prolonged price declines may result in our concluding in future periods that the impairment of these securities is other than temporary, which would require a charge to earnings to write down these securities to their fair value. Any charges for other-than-temporary impairment would not impact cash flow, tangible capital or liquidity.

Failure to resolve the Pennsylvania state budget impasse could hurt our profits, asset values and liquidity.

The Company makes loans to, invests in securities issued by, and maintains deposit accounts of Pennsylvania municipalities, primarily school districts. Until funding was distributed in January 2016, the state budget impasse resulted in the non-receipt by municipalities of state subsidies, which is a significant source of cash flow needed to meet their financial obligations. If the budget impasse remains unresolved, we may incur losses on loans granted to municipalities as well as incur losses, including impairment losses as a result of credit rating downgrades or otherwise, on municipal securities in which we invest. The continuing budget impasse may also reduce municipal funds on deposit with the Company, which could hurt our liquidity and our earnings if we would have to resort to higher cost funding sources to meet our liquidity needs.

Income from secondary mortgage market operations is volatile, and we may incur losses or charges with respect to our secondary mortgage market operations which would negatively affect our earnings.

We generally sell in the secondary market the longer term fixed-rate residential mortgage loans that we originate, earning non-interest income in the form of gains on sale. When interest rates rise, the demand for mortgage loans tends to fall and may reduce the number of loans available for sale. Furthermore, the prolonged low interest rate environment has reduced the demand for loans available for sale. In addition to interest rate levels, weak or deteriorating economic conditions also tend to reduce loan demand. Although we sell loans in the secondary market without recourse, we are required to give customary representations and warranties to the buyers. If we breach those representations and warranties, the buyers can require us to repurchase the loans and we may incur a loss on the repurchase. Because we generally retain the servicing rights on the loans we sell in the secondary market, we are required to record a mortgage servicing right asset, which we test annually for impairment. The value of mortgage

servicing rights tends to increase with rising interest rates and to decrease with falling interest rates. If we are required to take an impairment charge on our mortgage servicing rights our earnings would be adversely affected.

As a result of the acquisition of FNB, the Bank acquired a portfolio of loans sold to the FHLB, which were sold under the Mortgage Partnership Finance Program ("MPF"). The Bank is no longer an active participant in the MPF program. The MPF portfolio balance was $40,437,000 at December 31, 2015, respectively. The FHLB maintains a first-loss position for the MPF portfolio that totals $104,000. Should the FHLB exhaust its first-loss position, recourse to the Bank's credit enhancement would be up to the next $4,345,000 of losses. The Bank has not experienced any losses for the MPF portfolio.

The Company’s financial condition and results of operations are dependent on the economy in the Bank’s market area.

The Bank’s primary market area consists of the Pennsylvania Counties of Bradford, Clinton, Potter, and Tioga in north central Pennsylvania and Allegany, Steuben, Chemung and Tioga Counties in southern New York. With the acquisition of FNB, south central Pennsylvania counties of Lebanon, Schuylkill and Berks represents a new market area. As of December 31, 2015, management estimates that approximately 92.1% of deposits and 77.0% of loans came from households whose primary address is located in the Bank’s primary market area. Because of the Bank’s concentration of business activities in its market area, the Company’s financial condition and results of operations depend upon economic conditions in its market area. Adverse economic conditions in our market areas could reduce our growth rate, affect the ability of our customers to repay their loans and generally affect our financial condition and results of operations. Conditions such as inflation, recession, unemployment, high interest rates and short money supply and other factors beyond our control may adversely affect our profitability. We are less able than a larger institution to spread the risks of unfavorable local economic conditions across a large number of diversified economies. Any sustained period of increased payment delinquencies, foreclosures or losses caused by adverse market or economic conditions in the States of Pennsylvania and New York could adversely affect the value of our assets, revenues, results of operations and financial condition. Moreover, we cannot give any assurance we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

A return of recessionary conditions could result in increases in our level of nonperforming loans and/or reduce demand for our products and services, which could have an adverse effect on our results of operations.

Although the U.S. economy is not currently in a recession, economic growth has been slow and uneven, and the percentage of people out of the workforce or uemployed remains elevated. A return to prolonged deteriorating economic conditions and/or continued negative developments in the domestic and international credit markets could significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. These events may cause us to incur losses and may adversely affect our financial condition and results of operations.

We may fail to realize all of the anticipated benefits of the acquisition of FNB.

With the FNB acquisition, the Company entered into a new banking market area. The success of the FNB acquisition will depend upon, in part, the Company’s ability to realize the anticipated benefits and cost savings from combining the businesses of the Company and FNB. To realize these anticipated benefits and cost savings, the businesses must be successfully combined and operated. If the Company is not able to achieve these objectives, the anticipated benefits, including growth and cost savings related to the combined businesses, may not be realized at all or may take longer to realize than expected. If the Company fails to realize the anticipated benefits of the acquisition, the Company’s results of operations could be adversely affected.

Regulation of the financial services industry is undergoing major changes, and future legislation could increaseour cost of doing business or harm our competitive position.

We are subject to extensive regulation, supervision and examination by the FRB and the PDB, our primary regulators, and by the FDIC, as insurer of our deposits. Such regulation and supervision governs the activities in which an institution and its holding company may engage and are intended primarily for the protection of the insurance fund and the depositors and borrowers of the Bank rather than for holders of our common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our profitability and operations. Future legislative changes could require changes to business practices or force us to discontinue businesses and potentially expose us to additional costs, liabilities, enforcement action and reputational risk.

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We are periodically subject to examination and scrutiny by a number of banking agencies and, depending upon the findings and determinations of these agencies, we may be required to make adjustments to our business that could adversely affect us.

Federal and state banking agencies periodically conduct examinations of our business, including compliance with applicable laws and regulations. If, as a result of an examination, a banking agency was to determine that the financial condition, capital resources, asset quality, asset concentration, earnings prospects, management, liquidity, sensitivity to market risk or other aspects of any of our operations has become unsatisfactory, or that we or our management is in violation of any law or regulation, it could take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin "unsafe or unsound" practices, to require affirmative actions to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to change the asset composition of our portfolio or balance sheet, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance. If we become subject to such regulatory actions, our business, results of operations and reputation may be negatively impacted.

Strong competition within the Bank's market areas could hurt profits and slow growth.

The Bank faces intense competition both in making loans and attracting deposits. This competition has made it more difficult for the Bank to make new loans and at times has forced the Bank to offer higher deposit rates. Price competition for loans and deposits might result in the Bank earning less on loans and paying more on deposits, which would reduce net interest income. Competition also makes it more difficult to increase the volume of our loan and deposit portfolios. As of June 30, 2015, which is the most recent date for which information is available, we held 35.5% of the FDIC insured deposits in Bradford, Potter and Tioga Counties, Pennsylvania, which was the largest share of deposits out of eight financial institutions with offices in the area, and 6.1% of the FDIC insured deposits in Allegany County, New York, which was the fourth largest share of deposits out of five financial institutions with offices in this area. As of June 30, 2015, which is prior to the acquisition by the Company, FNB held 6.9% of the deposits in Lebanon County, Pennsylvania. This data does not include deposits held by credit unions. Competition also makes it more difficult to hire and retain experienced employees. Some of the institutions with which the Bank competes have substantially greater resources and lending limits than the Bank has and may offer services that the Bank does not provide. Management expects competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. The Bank's profitability depends upon its continued ability to compete successfully in its market area.

We rely on our management and other key personnel, and the loss of any of them may adversely affect our operations.

We are and will continue to be dependent upon the services of our executive management team. In addition, we will continue to depend on our ability to retain and recruit key commercial loan officers. The unexpected loss of services of any key management personnel or commercial loan officers could have an adverse effect on our business and financial condition because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Environmental liability associated with lending activities could result in losses.

In the course of our business, we may foreclose on and take title to properties securing our loans. If hazardous substances were discovered on any of these properties, we could be liable to governmental entities or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination. In addition, if we

arrange for the disposal of hazardous or toxic substances at another site, we may be liable for the costs of cleaning up and removing those substances from the site even if we neither own nor operate the disposal site. Environmental laws may require us to incur substantial expenses and may materially limit use of properties we acquire through foreclosure, reduce their value or limit our ability to sell them in the event of a default on the loans they secure. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability.

Our ability to pay dividends is limited by law.

Our ability to pay dividends to our shareholders largely depends on our receipt of dividends from the Bank. The amount of dividends that the Bank may pay to us is limited by federal and state laws and regulations. We also may decide to limit the payment of dividends even when we have the legal ability to pay them in order to retain earnings for use in our business.

Federal and state banking laws, our articles of incorporation and our by-laws may have an anti-takeover effect.

Federal law imposes restrictions, including regulatory approval requirements, on persons seeking to acquire control over us. Pennsylvania law also has provisions that may have an anti-takeover effect. These provisions may serve to entrench management or discourage a takeover attempt that shareholders consider to be in their best interest or in which they would receive a substantial premium over the current market price.

We are subject to certain risks in connection with our use of technology

Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger, our deposits, our loans, and to deliver on-line and electronic banking services. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious code and cyber attacks that could have a security impact.

In addition, breaches of security may occur through intentional or unintentional acts by those having authorized or unauthorized access to our confidential or other information or the confidential or other information of our customers, clients, or counterparties. If one or more of such events were to occur, the confidential and other information processed and stored in, and transmitted through, our computer systems and networks could potentially be jeopardized, or could otherwise cause interruptions or malfunctions in our operations or the operations of our customers, clients, or counterparties. This could cause us significant reputational damage or result in our experiencing significant losses from fraud or otherwise.

Furthermore, we may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures arising from operational and security risks. Also, we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance we maintain.

In addition, we routinely transmit and receive personal, confidential, and proprietary information by e-mail and other electronic means. We have discussed and worked with our customers, clients, and counterparties to develop secure transmission capabilities, but we do not have, and may be unable to put in place, secure capabilities with all of these constituents, and we may not be able to ensure that these third parties have appropriate controls in place to protect the confidentiality of such information. Any interception, misuse, or mishandling of personal, confidential, or proprietary information being sent to or received from a customer, client, or counterparty could result in legal liability, regulatory action, and reputational harm, and could have a significant adverse effect on our competitive position, financial condition, and results of operations.

Our risk management framework may not be effective in mitigating risks and/or losses to us.

We have implemented a risk management framework to manage our risk exposure. This framework is comprised of various processes, systems and strategies, and is designed to manage the types of risk to which we are subject, including, among others, credit, market, liquidity, interest rate and compliance. Our framework also includes financial or other modeling methodologies which involve management assumptions and judgment. There is no assurance that our risk management framework will be effective under all circumstances or that it will adequately mitigate any risk or loss to us. If our framework is not effective, we could suffer unexpected losses and our business, financial condition, results of operations or prospects could be materially and adversely affected. We may also be subject to potentially adverse regulatory consequences.

ITEM 1B – UNRESOLVED STAFF COMMENTS.

Not applicable.

ITEM 2 – PROPERTIES.

The headquarters of the Company and Bank are located at 15 South Main Street, Mansfield, Pennsylvania. The building contains the central offices of the Company and Bank. Our bank owns twenty one banking facilities and leases four other facilities. All buildings owned by the Bank are free of any liens or encumbrances.

The net book value of owned banking facilities and leasehold improvements totaled $16,317,000 as of December 31, 2015. The properties are adequate to meet the needs of the employees and customers. We have equipped all of our facilities with current technological improvements for data processing.

ITEM 3 - LEGAL PROCEEDINGS.

The Company is not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Such routine legal proceedings in the aggregate are believed by management to be immaterial to the Company's financial condition or results of operations.

ITEM 4 – MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5 - MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

The Company's stock is not listed on any stock exchange, but it is quoted on the OTC Pink Market under the trading symbol CZFS. Prices presented in the table below are bid prices between broker-dealers published by the OTC Pink Market and the Pink Sheets Electronic Quotation Service. The prices do not include retail markups or markdowns or any commission to the broker-dealer. The bid prices do not necessarily reflect prices in actual transactions. Cash dividends are declared on a quarterly basis and are summarized in the table below

	2015		Dividends declared	2014		Dividends declared
	High	Low	per share	High	Low	per share
First quarter	$ 53.63	$ 49.39	$ 0.405	$ 52.56	$ 47.00	$ 0.385
Second quarter	50.14	48.00	0.405	53.56	50.02	0.385
Third quarter	49.89	45.50	0.510	52.59	50.86	1.000
Fourth quarter	49.22	45.50	0.410	53.34	51.51	0.400

The Company has paid dividends since April 30, 1984, the effective date of our formation as a bank holding company. The Company's Board of Directors expects that comparable cash dividends will continue to be paid by the Company in the future; however, future dividends necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors in existence at the time the Board of Directors considers a dividend policy. Cash available for dividend distributions to stockholders of the Company comes primarily from dividends paid to the Company by the Bank. Therefore, restrictions on the ability of the Bank to make dividend payments are directly applicable to the Company. Under the Pennsylvania Business Corporation Law of 1988, the Company may pay dividends only if, after payment, the Company would be able to pay debts as they become due in the usual course of our business and total assets will be greater than the sum of total liabilities. These regulatory policies could affect the ability of the Company to pay dividends or otherwise engage in capital distributions. Also see "Supervision and Regulation – Regulatory Restrictions on Bank Dividends," "Supervision and Regulation – Holding Company Regulation," and "Note 14 – Regulatory Matter" to the consolidated financial statements.

As of February 23, 2016, the Company had approximately 1,738 stockholders of record. The computation of stockholders of record excludes investors whose shares were held for them by a bank or broker at that date. The following table presents information regarding the Company's stock repurchases during the three months ended December 31, 2015:

Period	Total Number of Shares (or units Purchased)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1)

10/1/15 to 10/31/15	1	$48.15	1	176,746
11/1/15 to 11/31/15	3,147	$46.00	3,147	173,599
12/1/15 to 12/31/15	63	$46.00	63	173,536
Total	3,211	$46.00	3,211	173,536

(1) On January 17, 2012, the Company announced that the Board of Directors authorized the Company to repurchase up to 140,000 shares. The repurchases will be conducted through open-market purchases or privately negotiated transactions and will be made from time to time depending on market conditions and other factors. No time limit was placed on the duration of the share repurchase program. Any repurchased shares will be held as treasury stock and will be available for general corporate purposes.

(2) On October 20, 2015, the Company announced that the Board of Directors authorized the Company to repurchase up to an additional 150,000 shares. The repurchases will be conducted through open-market purchases or privately negotiated transactions and will be made from time to time depending on market conditions and other factors. No time limit was placed on the duration of the share repurchase program. Any repurchased shares will be held as treasury stock and will be available for general corporate purposes.

Set forth below is a line graph comparing the yearly dollar changes in the cumulative shareholder return on the Company's common stock against the cumulative total return of the S&P 500 Stock index, SNL Mid-Atlantic Bank Index and SNL Bank $500 Million to $1 Billion index for the period of seven fiscal years assuming the investment of $100.00 on December 31, 2008 and assuming the reinvestment of dividends. The $1 Billion to $5 Billion Index was added to the chart in 2015 due to the Company exceeding $1.0 billion in assets in December as a result of the FNB acquisition. The shareholder return shown on the graph below is not necessarily indicative of future performance and was obtained from SNL Financial LC, Charlottesville, VA.

	Period Ending							
Index	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Citizens Financial Services, Inc.	100.00	139.87	210.87	204.87	268.13	362.46	378.63	358.26
S&P 500	100.00	126.46	145.51	148.59	172.37	228.19	259.43	263.02
SNL Mid-Atlantic Bank	100.00	105.27	122.81	92.26	123.59	166.59	181.49	188.30
SNL Bank $1B-$5B	100.00	71.68	81.25	74.10	91.37	132.87	138.93	155.51
SNL Bank $500M-$1B	100.00	95.24	103.96	91.46	117.25	152.05	166.81	188.27

ITEM 6 - SELECTED FINANCIAL DATA.

The following table sets forth certain financial data as of and for each of the years in the five year period ended December 31, 2015:

(in thousands, except share data)	2015	2014	2013	2012	2011
Interest and dividend income	$ 35,653	$ 35,291	$ 36,234	$ 38,085	$ 38,293
Interest expense	4,820	4,953	6,315	7,659	9,683
Net interest income	30,833	30,338	29,919	30,426	28,610
Provision for loan losses	480	585	405	420	675
Net interest income after provision for loan losses	30,353	29,753	29,514	30,006	27,935
Non-interest income	6,994	6,740	6,982	7,364	6,625
Investment securities gains, net	429	616	441	604	334
Non-interest expenses	23,429	20,165	19,810	19,428	18,452
Income before provision for income taxes	14,347	16,944	17,127	18,546	16,442
Provision for income taxes	2,721	3,559	3,752	4,331	3,610
Net income	$ 11,626	$ 13,385	$ 13,375	$ 14,215	$ 12,832
Per share data:					
Net income - Basic (1)	$ 3.84	$ 4.41	$ 4.38	$ 4.61	$ 4.12
Net income - Diluted (1)	3.83	4.40	4.38	4.60	4.12
Cash dividends declared (1)	1.73	2.17	1.21	1.49	1.08
Stock dividend	0%	1%	5%	1%	1%
Book value (1) (2)	35.97	32.83	30.64	27.62	24.64
End of Period Balances:					
Total assets	$1,162,984	$ 925,048	$ 914,934	$ 882,427	$ 878,567
Total investments	359,737	306,146	317,301	310,252	318,823
Loans	695,031	554,105	540,612	502,463	487,509
Allowance for loan losses	7,106	6,815	7,098	6,784	6,487
Total deposits	988,031	773,933	748,316	737,096	733,993
Total borrowings	41,631	41,799	66,932	46,126	53,882
Stockholders' equity	119,760	100,528	92,056	89,475	81,468
Key Ratios					
Return on assets (net income to average total assets)	1.22%	1.48%	1.51%	1.62%	1.52%
Return on equity (net income to average total equity)	11.20%	13.73%	14.89%	17.48%	17.86%
Equity to asset ratio (average equity to average					

total assets, excluding other comprehensive income)	10.91%	10.74%	10.13%	9.26%	8.49%
Net interest margin	3.76%	3.84%	3.87%	3.99%	3.94%
Efficiency	54.50%	48.61%	48.12%	46.10%	46.23%
Dividend payout ratio (dividends declared divided by net income)	46.00%	49.32%	27.63%	32.37%	26.30%
Tier 1 leverage	11.01%	10.99%	10.42%	9.70%	8.83%
Common equity risk based capital	14.14%	N/A	N/A	N/A	N/A
Tier 1 risk-based capital	15.20%	17.30%	16.44%	16.21%	14.94%
Total risk-based capital	16.23%	18.55%	17.75%	17.50%	16.23%
Nonperforming assets/total loans	1.22%	1.67%	1.88%	1.83%	2.11%
Nonperforming loans/total loans	1.03%	1.34%	1.63%	1.71%	1.94%
Allowance for loan losses/total loans	1.02%	1.23%	1.31%	1.35%	1.33%
Net charge-offs/average loans	0.03%	0.16%	0.02%	0.02%	0.02%

(1) Amounts were adjusted to reflect stock dividends.
(2) Calculation excludes accumulated other comprehensive income (loss).

ITEM 7 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

CAUTIONARY STATEMENT

We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of the Company, the Bank, First Citizens Insurance Agency, Inc. or the Company on a consolidated basis. When we use words such as "believes," "expects," "anticipates," or similar expressions, we are making forward-looking statements. Forward-looking statements may prove inaccurate. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements:

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

Additional factors are discussed in this Annual Report on Form 10-K under "Item 1A. Risk Factors." These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Forward-looking statements speak only as of the date they are made and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date of the forward-looking statements or to reflect the occurrence of unanticipated events. Accordingly, past results and trends should not be used by investors to anticipate future results or trends.

INTRODUCTION

The following is management's discussion and analysis of the significant changes in financial condition, the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for the Company. Our Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the audited consolidated financial statements and related notes. Except as noted, tabular information is presented in thousands of dollars.

Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga, Clinton and Bradford counties in north central Pennsylvania, Lebanon, Berks and Schuylkill counties in south central Pennsylvania and Allegany county in southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 25 banking facilities, 24 of which operate as bank branches. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Mansfield Wal-Mart Super Center, Mill Hall, Schuylkill Haven, Friedensburg, Mt. Aetna, Fredericksburg and three branches near the city of Lebanon, Pennsylvania. In New York, our office is in Wellsville.

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

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

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

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

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

Regulatory risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company and its subsidiary. We cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations. We cannot anticipate additional requirements or additional compliance efforts regarding the Bank Secrecy Act, Dodd-Frank Act or USA Patriot Act, or regulatory burdens regarding the ever increasing information theft and fraudulent activities impacting our customers and the banking industry in general.

Readers should carefully review the risk factors described in other documents our Company files with the SEC, including the annual reports on Form 10-K, the quarterly reports on Form 10-Q and any current reports on Form 8-K filed by us.

TRUST AND INVESTMENT SERVICES; OIL AND GAS SERVICES

Our Investment and Trust Division is committed to helping our customers meet their financial goals. The Trust Division offers professional trust administration, investment management services, estate planning and administration, custody of securities and individual retirement accounts. Assets held by the Bank in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Bank. As of December 31, 2015 and 2014, assets owned and invested by customers of the Bank through the Bank's investment representatives totaled $119.7 million and $111.7 million, respectively. Additionally, as summarized in the table below, the Trust Department had assets under management as of December 31, 2015 and 2014 of $110.2 million and $100.7 million, respectively. The increase in assets under management is due to several factors with the primary increased being due to the acquisition of FNB, which increased assets under management by $12.4 million. The Company also assigned a value to mineral rights in 2015 that resulted in a $2.8 million increase. These increases were offset by net withdrawals/account closings of $6.2 million. Changes in market values resulted in an approximately $500,000 increase in assets under management.

(market values - in thousands)	2015	2014
INVESTMENTS:		
Bonds	$ 16,425	$ 15,558
Stock	18,574	17,925
Savings and Money Market Funds	12,437	12,395
Mutual Funds	58,644	53,456
Mineral interests	2,781	-
Mortgages	686	701
Real Estate	565	637
Miscellaneous	68	49
TOTAL	$ 110,180	$ 100,721
ACCOUNTS:		
Trusts	26,746	21,268
Guardianships	1,274	1,684
Employee Benefits	46,888	41,289
Investment Management	35,268	36,478
Custodial	4	2
TOTAL	$ 110,180	$ 100,721

Our financial consultants offer full service brokerage and financial planning services throughout the Bank's market areas. Appointments can be made at any Bank branch. Products such as mutual funds, annuities, health and life insurance are made through our insurance subsidiary, First Citizens Insurance Agency, Inc.

In addition to the trust and investment services offered we have a mineral management division, which serves as a network of experts to assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. As of December 31, 2015, customers owning 6,653 acres have signed agreements with the Bank that provide for the Bank to manage oil and gas matters related to the customers land, which may include negotiating lease payments and royalty percentages, resolving leasing issues, accounting for and ensuring the accuracy of royalty checks, distributing revenue to satisfy investment objectives and providing customized reports outlining payment and distribution information.

RESULTS OF OPERATIONS

Net income for the year ended December 31, 2015 was $11,626,000, which represents a decrease of $1,759,000, or 13.1%, when compared to the 2014 related period. Net income for the year ended December 31, 2014 was $13,385,000, which represents an increase of $10,000, or 0.1%, when compared to the 2013 related period. Basic earnings per share were $3.84, $4.41, and $4.38 for the years ended 2015, 2014 and 2013, respectively. Diluted earnings per share were $3.83, $4.40 and $4.38 for the years ended 2015, 2014 and 2013, respectively.

Net income is influenced by five key components: net interest income, provision for loan losses, non-interest income, non-interest expenses, and the provision for income taxes.

Net Interest Income

The most significant source of revenue is net interest income; the amount of interest earned on interest-earning assets exceeding interest paid on interest-bearing liabilities. Factors that influence net interest income are changes in volume of interest-earning assets and interest-bearing liabilities as well as changes in the associated interest rates.

The following table sets forth our Company's average balances of, and the interest earned or incurred on, each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and rate "spread" created. It should be noted that average balances and rates for 2015 were slightly impacted by the acquisition of FNB, which closed on December 11, 2015:

Analysis of Average Balances and Interest Rates

	2015			2014			2013		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%	$	$	%
ASSETS									
Short-term investments:									
Interest-bearing deposits at banks	12,218	20	0.16	8,479	9	0.11	15,024	25	0.17
Total short-term investments	12,218	20	0.16	8,479	9	0.11	15,024	25	0.17
Interest bearing time deposits at banks	6,215	122	1.97	3,651	73	2.00	743	15	2.02
Investment securities:									
Taxable	202,991	3,320	1.64	212,338	3,531	1.66	215,746	3,807	1.76
Tax-exempt (3)	97,852	4,776	4.88	96,954	5,082	5.24	92,911	5,159	5.55
Total investment securities	300,843	8,096	2.69	309,292	8,613	2.78	308,657	8,966	2.90
Loans:									
Residential mortgage loans	182,877	10,059	5.50	187,057	10,582	5.66	181,887	10,941	6.02
Construction loans	8,518	438	5.14	5,237	247	4.71	13,098	647	4.94
Commercial & agricultural loans	292,518	15,294	5.23	270,164	14,618	5.41	252,242	14,794	5.87
Loans to state & political subdivisions	85,631	3,815	4.45	69,440	3,225	4.64	59,759	2,647	4.43
Other loans	8,448	676	8.00	8,643	703	8.13	9,762	802	8.22
Loans, net of discount (2)(3)(4)	577,992	30,282	5.24	540,541	29,375	5.43	516,748	29,831	5.77
Total interest-earning assets	897,268	38,520	4.29	861,963	38,070	4.42	841,172	38,837	4.62
Cash and due from banks	4,197			3,781			3,750		
Bank premises and equipment	12,837			11,454			11,375		
Other assets	36,781			30,152			29,905		
Total non-interest earning assets	53,789			45,387			45,030		
Total assets	951,083			907,350			886,202		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									

NOW accounts	230,675	801	0.35	219,473	764	0.35	209,275	791	0.38
Savings accounts	119,021	144	0.12	101,639	119	0.12	92,095	146	0.16
Money market accounts	98,452	481	0.49	91,373	424	0.46	85,688	405	0.47
Certificates of deposit	250,952	2,687	1.07	257,723	3,040	1.18	271,862	3,765	1.38
Total interest-bearing deposits	699,100	4,113	0.59	670,208	4,347	0.65	658,920	5,107	0.78
Other borrowed funds	36,700	707	1.93	39,209	606	1.55	42,214	1,208	2.86
Total interest-bearing liabilities	735,800	4,820	0.66	709,417	4,953	0.70	701,134	6,315	0.90
Demand deposits	102,977			92,878			87,496		
Other liabilities	8,510			7,578			7,767		
Total non-interest-bearing liabilities	111,487			100,456			95,263		
Stockholders' equity	103,796			97,477			89,805		
Total liabilities & stockholders' equity	951,083			907,350			886,202		
Net interest income		33,700			33,117			32,522	
Net interest spread (5)			3.63%			3.72%			3.72%
Net interest income as a percentage of average interest-earning assets			3.76%			3.84%			3.87%
Ratio of interest-earning assets to interest-bearing liabilities			1.22			1.22			1.20

(1) Averages are based on daily averages.
(2) Includes loan origination and commitment fees.
(3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using
a statutory federal income tax rate of 34%.
(4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.
(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets
and the average rate paid on interest-bearing liabilities.

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Tax exempt interest revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the 34% Federal statutory rate. Accordingly, tax equivalent adjustments for investments and loans have been made accordingly to the previous table for the years ended December 31, 2015, 2014 and 2013, respectively (in thousands):

	2015	2014	2013
Interest and dividend income from investment securities, interest bearing time deposits and short-term investments (non-tax adjusted)	$ 6,614	$ 6,967	$ 7,252
Tax equivalent adjustment	1,624	1,728	1,754
Interest and dividend income from investment securities, interest bearing time deposits and short-term investments (tax equivalent basis)	$ 8,238	$ 8,695	$ 9,006

	2015	2014	2013
Interest and fees on loans (non-tax adjusted)	$ 29,039	$ 28,324	$ 28,982
Tax equivalent adjustment	1,243	1,051	849
Interest and fees on loans (tax equivalent basis)	$ 30,282	$ 29,375	$ 29,831

	2015	2014	2013
Total interest income	$ 35,653	$ 35,291	$ 36,234
Total interest expense	4,820	4,953	6,315
Net interest income	30,833	30,338	29,919
Total tax equivalent adjustment	2,867	2,779	2,603
Net interest income (tax equivalent basis)	$ 33,700	$ 33,117	$ 32,522

The following table shows the tax-equivalent effect of changes in volume and rates on interest income and expense (in thousands):

Analysis of Changes in Net Interest Income on a Tax-Equivalent Basis

	2015 vs. 2014 (1)			2014 vs. 2013 (1)		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
Interest Income:						
Short-term investments:						
Interest-bearing deposits at banks	$ 5	$ 6	$ 11	$ (9)	$ (7)	$ (16)
Interest bearing time deposits at banks	50	(1)	49	58	-	58
Investment securities:						
Taxable	(154)	(57)	(211)	(59)	(217)	(276)
Tax-exempt	47	(353)	(306)	270	(347)	(77)
Total investment securities	(107)	(410)	(517)	211	(564)	(353)
Total investment income	(52)	(405)	(457)	260	(571)	(311)
Loans:						
Residential mortgage loans	(234)	(289)	(523)	328	(687)	(359)
Construction loans	166	25	191	(371)	(29)	(400)
Commercial & agricultural loans	1,141	(465)	676	1,947	(2,123)	(176)
Loans to state & political subdivisions	715	(125)	590	445	133	578
Other loans	(16)	(11)	(27)	(91)	(8)	(99)
Total loans, net of discount	1,772	(865)	907	2,258	(2,714)	(456)
Total Interest Income	1,720	(1,270)	450	2,518	(3,285)	(767)
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	39	(2)	37	43	(70)	(27)
Savings accounts	21	4	25	18	(45)	(27)
Money Market accounts	34	23	57	26	(7)	19

Certificates of deposit	(77)	(276)	(353)	(188)	(537)	(725)
Total interest-bearing deposits	17	(251)	(234)	(101)	(659)	(760)
Other borrowed funds	(35)	136	101	(81)	(521)	(602)
Total interest expense	(18)	(115)	(133)	(182)	(1,180)	(1,362)
Increase (decrease) in net interest income	$ 1,738	$ (1,155)	$ 583	$ 2,700	$ (2,105)	$ 595

(1) The portion of the total change attributable to both volume and rate changes during the year has been allocated to volume and rate components based upon the absolute dollar amount of the change in each component prior to allocation.

2015 vs. 2014

Tax equivalent net interest income for 2015 was $33,700,000 compared with $33,117,000 for 2014, an increase of $583,000 or 1.8%. Total interest income increased $450,000, as loan interest income increased $907,000, which was offset by a decrease in total investment income of $457,000. Interest expense decreased $133,000 from 2014.

Total tax equivalent interest income from investment securities decreased $517,000 in 2015 from 2014. The average tax-effected yield on our investment portfolio decreased from 2.78% in 2014 to 2.69% in 2015. This had the effect of decreasing interest income by $410,000 due to rate, the majority of which was related to non-taxable securities whose yield decreased from 5.24% in 2014 to 4.88% in 2015. The average balance of investment securities decreased $8.4 million, which had an effect of decreasing interest income by $107,000 due to volume. During 2015, there were significant fluctuations in the yield on investments as a result of economic indicators in the United States and global markets, turbulence in foreign markets and comments made by the Federal Reserve about raising the Fed funds rate and the actual increase in the Fed funds rate of 25 bps in late 2015. These factors led to a further flattening of the yield curve in late 2015, which has continued into 2016. Prior to the acquisition close, we chose to fund a portion of our loan growth from the cash flows from the investment portfolio, which were not reinvested in the bond market. For the investment cash flows that were reinvested, we monitored the trading ranges for various investment products and limited purchases to times when yields were in the top third of the trading range. Additionally, for the purchases made prior to the acquisition, the investment strategy in 2015 was to purchase agency securities with maturities of less than five years and high quality municipal bonds with high coupons. The acquisition of FNB increased the liquidity during this time of volatility in the investment markets. Due to the amount of liquidity obtained as part of the acquisition, purchases made subsequent to the acquisition included US treasury securities as the spread between agency and treasuries on the short end of the curve was insignificant and therefore treasury securities were purchased. Additionally, mortgage backed securities were purchased to provide a higher yield than agencies. The Bank believes its investment strategy has appropriately mitigated its interest rate risk exposure in the event of rising interest rates, while also providing sufficient cashflows to fund loan growth expected as a result of the acquisition. The investment strategy benefits from the fact that high coupon municipal bonds generally have less price volatility in rising rate scenarios than similar lower coupon municipal bonds.

In total, loan interest income increased $907,000 in 2015 from 2014. The average balance of our loan portfolio increased by $37.5 million in 2015 compared to 2014, which resulted in an increase in interest income of $1,772,000 due to volume. Offsetting this was a decrease in average yield on total loans from 5.43% in 2014 to 5.24% in 2015 resulting in a decrease in interest income of $865,000 due to rate.

Interest income on residential mortgage loans decreased $523,000. The change due to rate was a decrease of $289,000 as the average yield on residential mortgages decreased from 5.66% in 2014 to 5.50% in 2015. Additionally, the average balance of residential mortgage loans decreased $4.2 million, resulting in a decrease of $234,000 due to volume. Loan demand for conforming mortgages in 2015 increased over demand in 2014 as a result of a decrease in interest rates in the secondary market. Additionally, demand for nonconforming loans remained limited. Due to the decrease in rates in the secondary market, we did not portfolio as many loans that qualified for sale in 2015 as we did in 2014. In 2015, the Company added to its portfolio $2.0 million of conforming mortgages with maturities of less than 15 years compared to $5.1 million of similar loans in 2014. The Company originated loans to be sold of $18.9 million during 2015, which compares to $11.1 million originated and sold in 2014. Currently, all loans sold by the Bank are sold without recourse, with servicing retained. As a result of the acquisition completed in 2015, the Bank obtained a portfolio of serviced loans that include recourse, which totaled $40.4 million at December 31, 2015.

The average balance of construction loans increased $3.3 million from 2014 to 2015, due to several large projects in progress during 2015, which resulted in an increase of $166,000 in interest income. Additionally, the average yield on construction loans increased from 4.71% to 5.14%, which correlated to a $25,000 increase in interest income.

The Company attributes the increase in state and political loans, other commercial and agricultural, commercial real estate and agricultural real estate loans to the Company's experienced lenders and their ability to identify and meet the needs of our customers while providing growth opportunities for the Company's loan portfolio. We also look at commercial relationships as a way to obtain deposits from farmers, small businesses and municipalities throughout our market area. During 2015, there was an increase in pricing pressure for loans that has resulted in the Bank reducing loan rates and/or changing the terms of loans in order to maintain the relationship. We believe our lenders are adept at customizing and structuring loans to customers that meet their needs and satisfy our commitment to credit quality. In many cases, the Bank works with the United States Department of Agriculture's (USDA) and Small Business Administration (SBA) guaranteed loan programs to offset risk and to further promote economic growth in our market area. During 2015, despite these competitive pressures, the average balance of commercial and agricultural loans increased $22.4 million which had a positive impact of $1,141,000 on total interest income due to volume. Offsetting the increase due to volume, the average yield on commercial and agricultural loans decreased from 5.41% in 2014 to 5.23% in 2015, decreasing interest income by $465,000. The average balance of loans to state and political subdivisions increased $16.2 million from 2014 to 2015 which had a positive impact of $715,000 on total interest income due to volume. The average tax equivalent yield on loans to state and political subdivisions decreased from 4.64% in 2014 to 4.45% in 2015, decreasing interest income by $125,000.

Total interest expense decreased $133,000 in 2015 compared to 2014. The decrease is primarily attributable to a change in average rate from .70% in 2014 to .66% in 2015, which had the effect of decreasing interest expense by $115,000. The continued low interest rate environment prompted by the Federal Reserve had the effect of decreasing our rates on certificate of deposit products. While the Company's rates on certificate of deposit products are below historical averages they are competitive with rates paid by other institutions in the marketplace. The average balance of interest bearing liabilities increased $26.4 million from 2014 to 2015. Certificates of deposit and other borrowed funds decreased $6.8 million and $2.5 million, respectively, which resulted in a decrease in interest expense due to volume of $112,000. These decreases were offset by increases in NOW accounts of $11.2 million, savings accounts of $17.4 million and money market accounts of $7.1 million. The cumulative effect of these increases was an increase in interest expense of $94,000.

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The average balance of certificates of deposit decreased $6.8 million causing a decrease in interest expense of $77,000. In addition, as a result of the continued low rate environment, there was a decrease in the average rate on certificates of deposit from 1.18% to 1.07% resulting in a decrease in interest expense of $276,000. The continued low interest rate environment, both short-term and longer-term rates, has contributed to the decline in certificate of deposit balances. Customers, who typically utilize certificate of deposits as a means of generating income or as a longer term investment option, continue to move funds into money market and savings accounts in order to maintain flexibility for potentially rising interest rates.

The average balance of other borrowed funds decreased $2.5 million causing a decrease in interest expense of $35,000. Offsetting this decrease, there was an increase in the average rate on other borrowed funds from 1.55% to 1.93% resulting in an increase in interest expense of $136,000. The increase in rate on borrowed funds was the result of the taking out a long term borrowing during the first quarter of 2015 and a decrease in the amount of funds borrowed overnight from the Federal Home Loan Bank of Pittsburgh as a result of an increase in deposit levels.

Our net interest spread for 2015 and 2014 was 3.63%. The current economic situation has resulted in a flattening of the yield curve. It should be noted that there is currently more downward pressure on the pricing of interest earning assets than there is on interest bearing liabilities due to the rates that are currently being offered. Should short or long-term interest rates move in such a way that results in a further flattened or inverted yield curve, we would anticipate additional pressure on our margin.

2014 vs. 2013

Tax equivalent net interest income for 2014 was $33,117,000 compared with $32,522,000 for 2013, an increase of $595,000 or 1.8%. Total interest income decreased $767,000, as total investment income decreased $311,000 and loan interest income decreased $456,000. Offsetting the decrease in interest income, interest expense decreased $1,362,000 from 2013.

Total tax equivalent interest income from investment securities decreased $353,000 in 2014 from 2013. The average tax-effected yield on our investment portfolio decreased from 2.90% in 2013 to 2.78% in 2014. This had the effect of decreasing interest income by $564,000 due to rate, the majority of which was related to non-taxable securities whose yield decreased from 5.55% in 2013 to 5.24% in 2014. The average balance of investment securities increased $635,000, which had an effect of increasing interest income by $211,000 due to volume. During 2014, there was a flattening of the treasury yield curve as a result of a rise in rates on the short end of the yield curve with no corresponding increase in long term rates. In fact, rates related to longer term instruments decreased during 2014. The increase in short term rates was due to an expectation of a rise in the federal fund rates with the ending of the Federal Reserve's quantitative easing. As a result, the investment strategy during 2014 was to purchase agency securities with maturities of less than four years, which was the steepest part of the yield curve during 2014, and high quality municipal bonds with high coupons.

In total, loan interest income decreased $456,000 in 2014 from 2013. The average balance of our loan portfolio increased by $23.8 million in 2014 compared to 2013, which resulted in an increase in interest income of $2,258,000 due to volume. Offsetting this was a decrease in average yield on total loans from 5.77% in 2013 to 5.43% in 2014 resulting in a decrease in interest income of $2,714,000 due to rate.

Interest income on residential mortgage loans decreased $359,000. The change due to rate was a decrease of $687,000 as the average yield on residential mortgages decreased from 6.02% in 2013 to 5.66% in 2014. Offsetting this decrease was an increase of $328,000 due to volume as the average balance of residential mortgage loans increased $5.2 million. During 2014, the Company added to its portfolio $5.1 million of conforming mortgages with maturities of less than 15 years that would typically be sold due to lower nonconforming loan demand. The Company originated

and sold $11.1 million of conforming mortgages in 2014.

The average balance of construction loans decreased $7.9 million from 2013 to 2014, due to the completion of several projects, which resulted in a decrease of $371,000 in interest income. Additionally, the average yield on construction loans decreased from 4.94% to 4.71%, which correlated to a $29,000 decrease in interest income.

During 2014, the average balance of commercial and agricultural loans increased $17.9 million which had a positive impact of $1,947,000 on total interest income due to volume. Offsetting the increase due to volume, the average yield on commercial and agricultural loans decreased from 5.87% in 2013 to 5.41% in 2014, decreasing interest income by $2,123,000. The Company focus during 2014 was to grow its commercial and agricultural loan portfolio, utilizing its strong and experienced team of business development lenders.

The average balance of loans to state and political subdivisions increased $9.7 million from 2013 to 2014 which had a positive impact of $445,000 on total interest income due to volume. Part of the growth during 2014 was the result of municipalities in our area that continued to borrow funds to ensure compliance with U.S. Environmental Protection Agency laws and regulations impacting the Chesapeake Bay watershed. Additionally, the Company participated in hospital loans with other community banks, both in and out of our primary markets, to meet the needs of these customers. The average tax equivalent yield on loans to state and political subdivisions increased from 4.43% in 2013 to 4.64% in 2014, increasing interest income by $133,000.

Total interest expense decreased $1,362,000 in 2014 compared to 2013. The decrease is primarily attributable to a change in average rate from .90% in 2013 to .70% in 2014, which had the effect of decreasing interest expense by $1,180,000. The low interest rate environment had the effect of decreasing our short and long term borrowing costs as well as rates on all deposit products. The average balance of interest bearing liabilities increased $8,283,000 from 2013 to 2014. Certificates of deposit and other borrowed funds decreased $14.1 million and $3.0 million, respectively, which resulted in a decrease in interest expense due to volume of $269,000. These decreases were offset by increases in NOW accounts of $10.2 million, savings accounts of $9.5 million and money market accounts of $5.7 million. The cumulative effect of these increases was an increase in interest expense of $87,000.

The average balance of certificates of deposit decreased $14.1 million causing a decrease in interest expense of $188,000. In addition, as a result of the continued low rate environment, there was a decrease in the average rate on certificates of deposit from 1.38% to 1.18% resulting in a decrease in interest expense of $537,000. The average balance of other borrowed funds decreased $3.0 million causing a decrease in interest expense of $81,000. In addition, there was a decrease in the average rate on other borrowed funds from 2.86% to 1.55% resulting in a decrease in interest expense of $521,000. The decrease in rate on borrowed funds was the result of the interest rate swap for the trust preferred securities maturing in December of 2013. This resulted in the interest rate on the trust preferred securities decreasing from 5.82% to 3.09%.

Our net interest spread for 2014 and 2013 was 3.72%.

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2015, we recorded a provision for loan losses of $480,000. The provision for 2015 was $105,000, or 18.0%, lower than the provision in 2014. The decrease in the provision for loan losses was primarily the result of the decrease in charge-offs the Company recorded in 2015 compared to 2014. (see also "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

For the year ended December 31, 2014, we recorded a provision for loan losses of $585,000. The provision for 2014 was $180,000, or 44.4%, higher than the same time period in 2013. The increase in the provision for loan losses was primarily the result of the increase in charge-offs the Company recorded in 2014. (see also "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

NON-INTEREST INCOME

The following table reflects non-interest income by major category for the periods ended December 31 (dollars in thousands):

	2015	2014	2013
Service charges	$ 4,126	$ 4,297	$ 4,453
Trust	673	688	694
Brokerage and insurance	720	567	444
Investment securities gains, net	429	616	441
Gains on loans sold	404	236	443
Earnings on bank owned life insurance	628	507	502
Other	443	445	446
Total	$ 7,423	$ 7,356	$ 7,423

	2015/2014 Change		2014/2013 Change	
	Amount	%	Amount	%
Service charges	$ (171)	(4.0)	$ (156)	(3.5)
Trust	(15)	(2.2)	(6)	(0.9)
Brokerage and insurance	153	27.0	123	27.7
Investment securities gains, (losses), net	(187)	(30.4)	175	39.7
Gains on loans sold	168	71.2	(207)	(46.7)
Earnings on bank owned life insurance	121	23.9	5	1.0
Other	(2)	(0.4)	(1)	(0.2)
Total	$ 67	0.9	$ (67)	(0.9)

2015 vs. 2014

Non-interest income increased $67,000 in 2015 from 2014, or 0.9%. We recorded investment securities gains totaling $429,000 compared with net gains of $616,000 in 2014. During 2015, we sold five agency securities for gains totaling $196,000, five mortgage backed securities in government sponsored entities for gains totaling $69,000, seven municipal bonds for gains totaling $99,000, a financial institution equity holding for a gain of $76,000 and a US Treasury note for a loss of $11,000 in order to take advantage of interest rate market conditions. As a result of the acquisition, we sold seven agency securities and three mortgage backed securities, as a result of their risk profile in a rising interest rate environment. These securities were sold upon the acquisition date and as a result no gains or losses were recorded on the sale. During 2014 we elected to sell eight agency securities, seven mortgage backed securities, several lots of an equity security, and one municipal security for gains of $177,000, $197,000, $101,000 and $172,000, respectively. We also sold two US Treasury securities for a loss of $31,000.

Gains on loans sold increased $168,000 compared to last year, which is the result of an increased level of refinancing activities in 2015 versus 2014 for conforming loans. During 2015, the Bank generated $19.2 million of loan sale proceeds, which was $8.1 million, or 72.6% more than the proceeds received in 2014.

Service charge income decreased by $171,000 in 2015 compared to 2014, but still continues to be the Company's primary source of non-interest income. The largest decrease was in fees charged to customers for insufficient funds, which experienced a decrease of $139,000. ATM income decreased $22,000 in 2015 compared to 2014 due to decreased usage of the Company's ATM machines by non-customers. Management continues to monitor regulatory changes to determine the level of impact that these regulations will have on the Company.

The increase in earnings on bank owned life insurance of $121,000 is primarily due to purchases of an additional $5.0 million of insurance made late in the fourth quarter of 2014. The increase in brokerage and insurance revenues of $153,000 is primarily due to sales to a new customer, with a large brokerage balance.

2014 vs. 2013

Non-interest income decreased $67,000 in 2014 from 2013, or 0.9%. We recorded investment securities gains totaling $616,000 compared with net gains of $441,000 in 2013. During 2014 we elected to sell eight agency securities, seven mortgage backed securities, several lots of an equity security, and one municipal security for gains of $177,000, $197,000, $101,000 and $172,000, respectively. We also sold two US Treasury securities for a loss of $31,000. During 2013 we elected to sell seven agency securities, nine mortgage backed securities, portions of three equity securities, four municipal securities and one corporate security for gains of $86,000, $356,000, $296,000, $87,000 and $2,000, respectively. We also sold one corporate security and two mortgage backed securities for losses of $246,000 and $140,000, respectively.

Gains on loans sold in 2014 decreased $207,000 compared to 2013, which is the result of a lower level of refinancing activities in 2014 versus 2013 for conforming loans. During 2014, the Bank generated $11.1 million of loan sale proceeds, but this was $10.8 million or 49.0% less than the proceeds received in 2013.

Service charge income decreased by $156,000 in 2014 compared to 2013. The largest decrease was in fees charged to customers for insufficient funds, which experienced a decrease of $153,000. ATM income decreased $18,000 in 2014 compared to 2013 due to decreased usage of the Company's ATM machines by non-customers. Service charge fees related to customers' usage of their debit cards increased by $22,000.

The increase in brokerage and insurance revenues was the result of hiring additional brokers in 2014 that resulted in additional business. There was also an in increase in brokerage activity as a result of increases in the stock market during 2014 as customers had renewed interest in non-bank investments in the low interest rate environment.

Non-interest Expenses

The following tables reflect the breakdown of non-interest expense by major category for the periods ended December 31 (dollars in thousands):

	2015	2014	2013
Salaries and employee benefits	$ 12,504	$ 11,505	$ 11,392
Occupancy	1,424	1,287	1,271
Furniture and equipment	506	362	492
Professional fees	846	820	781
FDIC insurance	464	461	450
ORE expenses	969	299	191
Pennsylvania shares tax	713	686	640
Merger and acquisition	1,103	237	55
Other	4,900	4,508	4,538
Total	$ 23,429	$ 20,165	$ 19,810

	2015/2014 Change		2014/2013 Change	
	Amount	%	Amount	%
Salaries and employee benefits	$ 999	8.7	$ 113	1.0
Occupancy	137	10.6	16	1.3
Furniture and equipment	144	39.8	(130)	(26.4)
Professional fees	26	3.2	39	5.0
FDIC insurance	3	0.7	11	2.4

ORE expenses		670	224.1	108	56.5
Pennsylvania shares tax		27	3.9	46	7.2
Merger and acquisition		866	365.4	182	330.9
Other		392	8.7	(30)	(0.7)
Total	$	3,264	16.2	$ 355	1.8

2015 vs. 2014

Non-interest expenses for 2015 totaled $23,429,000, which represents an increase of $3,264,000, compared with 2014 expenses of $20,165,000. Salary and benefit costs increased $999,000. Base salaries and related payroll taxes increased $597,000, primarily due to merit increases and additional head count as a result of continuing to implement the Company's strategic and expansion plans and, to a lesser extent, increased headcount as a result of the FNB acquisition. Full time equivalent staffing was 195 and 189 employees for 2015 and 2014, respectively. Health insurance related expenses increased $128,418 from 2014 due to increased claims experience in 2015. Retirement expenses increased $192,000 compared to 2014 as a result of actuarial changes and a decrease in earnings on pension plan assets.

The increases in occupancy and furniture and equipment was primarily related to the opening of the Mill Hall branch in the first quarter of 2015, which includes some one-time costs incurred as part of the opening. The increase in ORE expenses was primarily the result of recording several properties to fair value based on updated appraisals. During 2015, the Company experienced losses on ORE properties of $409,000 compared to losses of $16,400 in 2014. The other large increase in ORE expenses was the result of an increase in legal fees and real estate taxes on certain properties and loans in foreclosure.

The increase in merger and acquisition costs was the result of the completed FNB acquisition in 2015, which resulted in severance costs, professional fees to assist with the completion of the merger, and system conversion costs to combine financial systems and records.

The largest driver of the increase in other expenses is charge-offs related to fraudulent charges on our customers debit cards. In addition, increases in other expenses included office and printing supplies for the new Mill Hall branch and the acquired branches as part of the FNB transaction, travel related expenses as a result of opening the new Mill Hall branch and the acquisition, and amortization of the core deposit intangible associated with the acquisition.

2014 vs. 2013

Non-interest expenses for 2014 totaled $20,165,000 which represents an increase of $355,000, compared with 2013 expenses of $19,810,000. Salary and benefit costs increased $113,000. Base salaries and related payroll taxes increased $375,000, primarily due to merit increases and additional head count. Full time equivalent staffing was 189 and 186 employees for 2014 and 2013, respectively. Health insurance related expenses decreased $182,000 from 2013 due to significantly improved claims experience in 2014. Incentive costs increased $213,000 compared to 2013. Retirement expenses decreased $295,000 compared to 2013 mostly due to improved earnings on pension plan assets and a decrease in the net amortization and deferral of actuarial gains and losses.

The increase in merger and acquisition costs was the result of investigating merger targets during 2014, but did not result in a completed transaction. The increase in ORE expenses is due to the increase in foreclosed properties owned by the Company in 2014. Furniture and equipment costs decreased as a result of purchasing equipment for the online teller system implemented during 2013 and additional assets becoming fully depreciated.

Provision for Income Taxes

The provision for income taxes was $2,721,000, $3,559,000 and $3,752,000 for 2015, 2014 and 2013, respectively. The effective tax rates for 2015, 2014 and 2013 were 19.0%, 21.0%, and 21.9%, respectively.

Income before the provision for income taxes decreased by $2,597,000 in 2015 compared to 2014. As the result of this decrease and an increase in non-taxable investment and loan interest income, the provision for income taxes decreased by $838,000 when compared to 2014. We have managed our effective tax rate by remaining invested in tax-exempt municipal loans and bonds and investments in certain partnerships that provide the Company with tax credits.

Income before the provision for income taxes decreased by $183,000 in 2014 compared to 2013. As the result of this decrease and an increase in non-taxable investment and loan interest income, the provision for income taxes decreased by $193,000 when compared to 2013.

We are involved in four limited partnership agreements that established low-income housing projects in our market area. During 2015, 2014 and 2013, we recognized tax credits related to two of the four partnerships. The tax credits for the other two projects were fully utilized by December 31, 2012. We anticipate recognizing an aggregate of $1.0 million of tax credits over the next seven years.

FINANCIAL CONDITION

The following table presents ending balances (dollars in millions), growth and the percentage change during the past two years:

	2015 Balance	Increase	% Change	2014 Balance	Increase	% Change	2013 Balance
Total assets	$ 1,163.0	$ 238.0	25.7	$ 925.0	$ 10.1	1.1	$ 914.9
Total investments	359.7	53.6	17.5	306.1	(11.2)	(3.5)	317.3
Total loans, net	687.9	140.6	25.7	547.3	13.8	2.6	533.5
Total deposits	988.0	214.1	27.7	773.9	25.6	3.4	748.3
Total stockholders' equity	119.8	19.3	19.2	100.5	8.4	9.1	92.1

Cash and Cash Equivalents

Cash and cash equivalents totaled $24.4 million at December 31, 2015 compared with $11.4 million at December 31, 2014. The increase in cash and cash equivalents is the result of the Company's acquisition of FNB in December of 2015, which resulted in a significant cash increase. Management actively measures and evaluates its liquidity through our Asset – Liability committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

Investments

The following table shows the year-end composition of the investment portfolio for the five years ended December 31 (dollars in thousands):

	2015 Amount	% of Total	2014 Amount	% of Total	2013 Amount	% of Total	2012 Amount	% of Total	2011 Amount	% of Total
Available-for-sale:										
U. S. Agency securities	$ 199,591	55.5	$ 150,885	49.3	$ 152,189	48.0	$ 127,234	41.0	$ 168,600	52.9
U.S. Treasuries	10,082	2.8	4,849	1.6	11,309	3.6	4,947	1.6	-	-
Obligations of state & political subdivisions	102,863	28.6	105,036	34.3	95,005	29.9	100,875	32.5	101,547	31.9
Corporate obligations	14,565	4.0	13,958	4.6	16,802	5.3	22,109	7.1	8,460	2.7
Mortgage-backed securities	30,204	8.4	29,728	9.6	40,671	12.8	53,673	17.3	38,974	12.2
Equity securities	2,432	0.7	1,690	0.6	1,325	0.4	1,414	0.5	1,242	0.3
Total	$ 359,737	100.0	$ 306,146	100.0	$ 317,301	100.0	$ 310,252	100.0	$ 318,823	100.0

2015

The Company's investment portfolio increased by $53.6 million, or 17.5%, during the past year primarily due to the acquisition of FNB. As part of the acquisition, we acquired $17.8 million of U.S. agency obligations, $1.2 million of mortgage backed securities, $1.8 million of state and local obligations and $3.0 million of corporate obligations. In addition, during 2015, we purchased $10.1 million of U.S treasuries, $74.5 million of U.S. agencies, $6.8 million of mortgage backed securities, $19.1 million of state and local obligations and $901,000 of equity securities, which helped to offset the $5.7 million of principal repayments and $42.5 million of calls and maturities that occurred during the year. We also sold $30.5 million of bonds and equities at a net gain of $429,000. The market value of our investment portfolio decreased approximately $1.3 million in 2015 due to interest rate fluctuations. Excluding our short term investments consisting of monies held primarily at the Federal Reserve, the effective yield on our investment portfolio for 2015 was 2.69% compared to 2.78% for 2014 on a tax equivalent basis.

During 2015, rates on the short end of the Treasury yield curve experienced an increase, as the result of the increase in the federal funds rate and the potential for additional increases in the federal funds rate in the near future, while the long end of the curve experienced significant volatility throughout the year and ended the year up slightly from 2014. The investment strategy in 2015 prior to the acquisition of FNB was to purchase agency securities with maturities of less than five years and high quality municipal bonds with high coupons. Due to the amount of liquidity obtained as part of the acquisition, purchases made subsequently included US Treasury securities as the spread between agency and treasuries on the short end of the curve was insignificant and thus the Treasury security was purchased. Additionally, mortgage backed securities were purchased to provide a higher yield than agencies. The Bank believes its investment strategy has appropriately mitigated its interest rate risk exposure in the event of rising interest rates while providing sufficient cashflows to fund loan growth expected as a result of the acquisition.

At December 31, 2015, the Company did not own any securities, other than government-sponsored and government-guaranteed mortgage-backed securities, that had an aggregate book value in excess of 10% of its stockholders' equity at that date.

The expected principal repayments (amortized cost) and average weighted yields for the investment portfolio (excluding equity securities) as of December 31, 2015, are shown below (dollars in thousands). Expected principal repayments, which include prepayment speed assumptions for mortgage-backed securities, are significantly different than the contractual maturities detailed in Note 3 of the consolidated financial statements. Yields on tax-exempt securities are presented on a fully taxable equivalent basis, assuming a 34% tax rate.

	One Year or Less		After One Year to Five years		After Five Years to Ten Years		After Ten Years		Total	
	Amortized Cost	Yield %	Amortized Cost	Yield %	Amortized Cost	Yield %	Amortized Cost	Yield %	Amortized Cost	Yield %
Available-for-sale securities:										
U.S. agency securities	$ 16,753	0.9	$ 179,937	1.4	$ 3,059	2.0	$ -	-	$ 199,749	1.4
U.S. treasuries	2,119	0.7	7,984	1.0	-	-	-	-	10,103	0.9
Obligations of state & political subdivisions	4,601	4.2	63,563	4.0	16,419	4.8	15,273	5.8	99,856	4.4
Corporate obligations	6,536	2.8	8,047	5.3	-	-	-	-	14,583	4.1
Mortgage-backed securities	7,809	2.0	14,017	2.1	6,936	2.2	1,345	2.4	30,107	2.1
Total available-for-sale	$ 37,818	1.8	$ 273,548	2.1	$ 26,414	3.8	$ 16,618	5.5	$ 354,398	2.4

At December 31, 2015, approximately 87.9% of the amortized cost of debt securities is expected to mature, call or pre-pay within five years or less. The Company expects that earnings from operations, the levels of cash held at the Federal Reserve and other correspondent banks, the high liquidity level of the available-for-sale securities, growth of deposits and the availability of borrowings from the Federal Home Loan Bank and other third party banks will be sufficient to meet future liquidity needs.

2014

The Company's investment portfolio decreased by $11.2 million, or 3.5%, during the past year. During 2014, we purchased $40.5 million of U.S. agency obligations, $15.2 million of state and local obligations and $602,000 of equity securities, which helped to offset the $6.7 million of principal repayments and $35.0 million of calls and maturities that occurred during the year. We also selectively sold $29.0 million of bonds and equities at a net gain of $616,000. The market value of our investment portfolio increased approximately $4.8 million in 2014 due to interest rate fluctuations. Excluding our short term investments consisting of monies held primarily at the Federal Reserve, the effective yield on our investment portfolio for 2014 was 2.78% compared to 2.90% for 2013 on a tax equivalent basis.

During 2014, rates on the short end of the Treasury yield curve experienced an increase, as the result of an expected rise in the federal funds rate in the near future due to the end of the quantitative easing program by the Federal Reserve, while the long end of the curve, particularly the 10 year treasury, experienced a decrease in excess of 80 basis points. These changes resulted in the market value of the investment portfolio increasing. As a result of these

items, the investment strategy during 2014 was to purchase agency securities with maturities of less than four years and high quality municipal bonds with high coupons.

At December 31, 2014, the Company did not own any securities, other than government-sponsored and government-guaranteed mortgage-backed securities, that had an aggregate book value in excess of 10% of its stockholders' equity at that date.

Loans

The Bank's lending efforts have historically focused on north central Pennsylvania and southern New York. With the acquisition of FNB, this focus will change to include opportunities in the Lebanon, Schuylkill and Berks County markets of south central, Pennsylvania. We originate loans primarily through direct loans to our existing customer base, with new customers generated by referrals from real estate brokers, building contractors, attorneys, accountants, corporate and advisory board members, existing customers and the Bank's website. The Bank offers a variety of loans although historically most of our lending has focused on real estate loans including residential, commercial, agricultural, and construction loans. As of December 31, 2015, approximately 74.0% of our loan portfolio consisted of real estate loans. All lending is governed by a lending policy that is developed and administered by management and approved by the Board of Directors.

The Bank primarily offers fixed rate residential mortgage loans with terms of up to 25 years and adjustable rate mortgage loans (with amortization schedules based up to 30 years) with interest rates and payments that adjust based on one, three, and five year fixed periods. Loan to value ratios are usually 80% or less with exceptions for individuals with excellent credit and low debt to income and/or high net worth. Adjustable rate mortgages are tied to a margin above the comparable Federal Home Loan Bank of Pittsburgh borrowing rate. Home equity loans are written with terms of up to 15 years at fixed rates. Home equity lines of credit are variable rate loans tied to the Prime Rate generally with a ten year draw period followed by a ten year repayment period. Home equity loans are typically written with a maximum 80% loan to value.

Commercial real estate loan terms are generally 20 years or less, with one to five year adjustable interest rates. The adjustable rates are typically tied to a margin above the comparable Federal Home Loan Bank of Pittsburgh borrowing rate with a maximum loan to value ratio of 80%. Where feasible, the Bank works with the United States Department of Agriculture's (USDA) and Small Business Administration (SBA) guaranteed loan programs to offset risk and to further promote economic growth in our market area. During 2015, we originated $5.5 million in USDA and SBA guaranteed commercial real estate loans.

Agriculture, and particularly dairy farming, is an important industry in our market area. Therefore, the Bank has developed an agriculture lending team with significant experience that has a thorough understanding of this industry. Agricultural loans focus on character, cash flow and collateral, while also taking into account the particular risks of the industry. Loan terms are generally 20 years or less, with one to five year adjustable interest rates. The adjustable rates are typically tied to a margin above the comparable Federal Home Loan Bank of Pittsburgh borrowing rate with a maximum loan to value of 80%. The Bank is a preferred lender under the USDA's Farm Service Agency (FSA) and participates in the FSA guaranteed loan program.

The Bank, as part of its commitment to the communities it serves, is an active lender for projects by our local municipalities and school districts. These loans range from short term bridge financing to 20 year term loans for specific projects. These loans are typically written at rates that adjust at least every five years. Due to the size of certain municipal loans, we have developed participation lending relationships with other community banks that allow us to meet regulatory compliance issues, while meeting the needs of the customer. At December 31, 2015, the aggregate balance of our participation loans with other lenders totaled $86.3 million.

Activity associated with exploration for natural gas significantly decreased in 2015 due to the low price of natural gas produced in our area. While the Bank has loaned to companies that service the exploration activities, the Bank did not

originate any loans to Companies performing the actual drilling and exploration activities. Loans made by the Company were to service industry customers which included trucking companies, stone quarries and other support businesses. We also originated loans to businesses and individuals for restaurants, hotels and apartment rentals that were developed and expanded to meet the housing and living needs of the gas workers. Due to our understanding of the industry and its cyclical nature, the loans made for natural gas-related activities were originated in a prudent and cautious manner and were subject to specific policies and procedures for lending to these entities, which included lower loan to value thresholds, shortened amortization periods, and expansion of our monitoring of loan concentrations associated with this activity.

The following table shows the year-end composition of the loan portfolio for the five years ended December 31 (dollars in thousands):

	2015		2014		2013		2012		2011	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate:										
Residential	$ 203,407	29.3	$ 185,438	33.5	$ 187,101	34.6	$ 178,080	35.4	$ 184,034	37.7
Commercial	237,542	34.2	190,945	34.5	193,087	35.7	176,710	35.2	165,826	34.0
Agricultural	57,822	8.3	24,639	4.4	22,001	4.1	18,015	3.6	19,224	3.9
Construction	15,011	2.2	6,353	1.1	8,937	1.7	12,011	2.4	8,481	1.7
Consumer	11,543	1.7	8,497	1.5	9,563	1.7	10,559	2.1	10,746	2.2
Other commercial and agricultural loans	71,206	10.2	58,516	10.6	54,029	10.0	47,880	9.5	44,299	9.1
State & political subdivision loans	98,500	14.1	79,717	14.4	65,894	12.2	59,208	11.8	54,899	11.4
Total loans	695,031	100.0	554,105	100.0	540,612	100.0	502,463	100.0	487,509	100.0
Less allowance for loan losses	7,106		6,815		7,098		6,784		6,487	
Net loans	$ 687,925		$ 547,290		$ 533,514		$ 495,679		$ 481,022	

	2015/2014 Change		2014/2013 Change	
	Amount	%	Amount	%
Real estate:				
Residential	$ 17,969	9.7	$ (1,663)	(0.9)
Commercial	46,597	24.4	(2,142)	(1.1)
Agricultural	33,183	134.7	2,638	12.0
Construction	8,658	136.3	(2,584)	(28.9)
Consumer	3,046	35.8	(1,066)	(11.1)
Other commercial and agricultural loans	12,690	21.7	4,487	8.3
State & political subdivision loans	18,783	23.6	13,823	21.0
Total loans	$ 140,926	25.4	$ 13,493	2.5

2015

Total loans grew $140.9 million in 2015 from $554.1 million at the end of 2014 to $695.0 million at the end of 2015. The primary driver of the increase was $115.2 million in loans acquired from the acquisition of FNB as of December 11, 2015. The remaining growth was the result of our continued emphasis on growing commercial, agricultural and municipal relationships through well collateralized loans to meet our customers' needs.

During 2015, exclusive of the FNB acquisition, the Company experienced growth in agricultural real estate loans of $13.1 million, state and political subdivision loans of $8.9 million, construction loans of $5.8 million, other

commercial and agricultural loans of $5.7 million and commercial real estate loans of $2.1 million. The increase in agricultural real estate, state and political loans, other commercial and agricultural loans and commercial real estate loans is attributable to the Company's experienced lenders and their ability to identify and meet the needs of our customers while providing growth opportunities for the Company's loan portfolio. We work closely with local municipalities and school districts to meet their needs that otherwise would be provided by the municipal bond market. We also look at commercial relationships as a way to obtain deposits from farmers, small businesses and municipalities throughout our market area. Commercial loan demand is subject to significant competitive pressures, the yield curve, and the strength of the overall national, regional and local economies. The opening of the Mill Hall branch resulted in loan growth of $13.1 million and was the primary contributor to the increase in agricultural loans independent of the acquisition of FNB. Commercial loan demand is subject to significant competitive pressures, the yield curve, the strength of the overall regional and national economy and the local economy.

Excluding the FNB acquisition, residential real estate loans experienced a decrease of $9.6 million during 2015. This decrease is attributable to an increase in loan demand for conforming mortgages, which the Company typically sells on the secondary market. During 2015, $18.9 million of loans were originated for sale on the secondary market, which compares to $11.1 million for 2014. In addition to the loans originated for sale, the Company added in 2015 $2.0 million to its residential real estate portfolio in 2015 of certain 15 year mortgage loans that met secondary market standards. During 2014, the Company did not sell $5.1 million of residential mortgages that met secondary market standards. For loans sold on the secondary market, the Company recognizes fee income for servicing these sold loans, which is included in non-interest income. Management continues to build technologies which make it easier and more efficient for customers to choose the Company for their mortgage needs.

2014

Total loans grew $13.5 million in 2014 from a balance of $540.6 million at the end of 2013 to $554.1 million at the end of 2014. Total loans grew 2.5% in 2014 compared with a 7.6% loan growth rate in 2013.

During 2014, the Company experienced growth in state and political subdivision loans, which increased $13.8 million or 21.0%, other commercial and agricultural loans which increased $4.5 million or 8.3% and agricultural real estate loans which increased $2.6 million or 12.0%. The Company did have several large commercial real estate loans payoff during 2014, which resulted in a decrease of $2.1 million, or 1.1%.

Residential real estate loans decreased $1.7 million during 2014. Loan demand for conforming mortgages slowed during 2014 when compared to 2013. During 2014, $11.1 million of loans were originated and sold on the secondary market, which compares to $20.2 million for 2013. Due to the decline in demand for non-conforming mortgages and the difficult investment environment, the Company decided that certain 15 year mortgage loans that met secondary market standards would not be sold on the secondary market, but would instead be held as part of the Bank's residential real estate portfolio. During 2014, the Company did not sell $5.1 million of residential mortgages that met secondary market standards. In 2013, the Company did not sell $7.5 million of loans, which met secondary market standards.

The decrease in construction loans of $2.6 million is attributable to transfers out of construction at completion to commercial, state and political subdivision loans and residential real estate during 2014.
The following table shows the maturity of commercial business and agricultural, state and political subdivision loans, commercial real estate loans, and construction loans as of December 31, 2015, classified according to the sensitivity to changes in interest rates within various time intervals (in thousands). The table does not include any estimate of prepayments which significantly shorten the average life of all loans and may cause our actual repayment experience to differ from that shown below. Demand loans having no stated schedule of repayments and no stated maturity are reported as due in one year or less.

	Commercial, municipal, agricultural	Real estate construction	Total
Maturity of loans:			
One year or less	$ 22,265	$ 2,208	$ 24,473
Over one year through five years	61,325	4,937	66,262
Over five years	381,480	7,866	389,346
Total	$ 465,070	$ 15,011	$ 480,081
Sensitivity of loans to changes in interest rates - loans due after December 31, 2016:			
Predetermined interest rate	$ 96,839	$ 6,178	$ 103,017
Floating or adjustable interest rate	345,966	6,625	352,591
Total	$ 442,805	$ 12,803	$ 455,608

Allowance for Loan Losses and Credit Quality Risk

The allowance for loan losses is maintained at a level which, in management's judgment, is adequate to absorb probable future loan losses inherent in the loan portfolio. The provision for loan losses is charged against current income. Loans deemed not collectable are charged-off against the allowance while subsequent recoveries increase the allowance. The following table presents an analysis of the change in the allowance for loan losses and a summary of our non-performing assets for the years ended December 31, 2015, 2014, 2013, 2012 and 2011. All non-accruing troubled debt restructurings (TDRs) are also included the non-accruing loans totals.

	December 31,				
	2015	2014	2013	2012	2011
Balance at beginning of period	$ 6,815	$ 7,098	$ 6,784	$ 6,487	$ 5,915
Charge-offs:					
Real estate:					
Residential	66	97	17	95	101
Commercial	84	516	62	2	29
Agricultural	-	-	-	-	-
Consumer	47	47	54	54	71
Other commercial and agricultural loans	41	250	1	21	6
Total loans charged-off	238	910	134	172	207
Recoveries:					
Real estate:					
Residential	-	-	5	-	-
Commercial	14	15	5	9	15
Agricultural	-	-	-	-	-
Consumer	33	27	33	33	57
Other commercial and agricultural loans	2	-	-	7	32
Total loans recovered	49	42	43	49	104
Net loans charged-off	189	868	91	123	103
Provision charged to expense	480	585	405	420	675
Balance at end of year	$ 7,106	$ 6,815	$ 7,098	$ 6,784	$ 6,487
Loans outstanding at end of period	$ 695,031	$ 554,105	$ 540,612	$ 502,463	$ 487,509
Average loans outstanding, net	$ 577,992	$ 540,541	$ 516,748	$ 496,822	$ 474,972
Non-performing assets:					
Non-accruing loans	$ 6,531	$ 6,599	$ 8,097	$ 8,067	$ 9,165
Accrual loans - 90 days or more past due	623	836	697	506	275
Total non-performing loans	$ 7,154	$ 7,435	$ 8,794	$ 8,573	$ 9,440
Foreclosed assets held for sale	1,354	1,792	1,360	616	860
Total non-performing assets	$ 8,508	$ 9,227	$ 10,154	$ 9,189	$ 10,300

Troubled debt restructurings (TDR)					
Non-accruing TDRs	$ 3,397	$ 3,654	$ 4,701	$ 4,834	$ 5,490
Accrual TDRs	2,243	2,502	2,510	193	123
Total troubled debt restructurings	$ 5,640	$ 6,156	$ 7,211	$ 5,027	$ 5,613
Net charge-offs to average loans	0.03%	0.16%	0.02%	0.02%	0.02%
Allowance to total loans	1.02%	1.23%	1.31%	1.35%	1.33%
Allowance to total non-performing loans	99.33%	91.66%	80.71%	79.13%	68.72%
Non-performing loans as a percent of loans net of unearned income	1.03%	1.34%	1.63%	1.71%	1.94%
Non-performing assets as a percent of loans net of unearned income	1.22%	1.67%	1.88%	1.83%	2.11%

The Company utilizes a disciplined and thorough loan review process based upon our internal loan policy approved by the Company's Board of Directors. The purpose of the review is to assess loan quality, analyze delinquencies, identify problem loans, evaluate potential charge-offs and recoveries, and assess general overall economic conditions in the markets served. An external independent loan review is performed on our commercial portfolio semi-annually for the Company. The external consultant is engaged to 1) review a minimum of 55% (60% of loans prior to 2013) of the dollar volume of the commercial loan portfolio on an annual basis, 2) new loans originated for over $1.0 million in the last year, 3) a majority of borrowers with commitments greater than or equal to $1.0 million, 4) review selected loan relationships over $750,000 which are over 30 days past due, or classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate. As part of this review, our underwriting process and loan grading system is evaluated.

Management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate as of December 31, 2015. However, future adjustments could be required if circumstances differ substantially from assumptions and estimates used in making the initial determination. A prolonged downturn in the economy, high unemployment rates, significant changes in the value of collateral and delays in receiving financial information from borrowers could result in increased levels of non-performing assets, charge-offs, loan loss provisions and reduction in income. Additionally, bank regulatory agencies periodically examine the Bank's allowance for loan losses. The banking agencies could require the recognition of additions to the allowance for loan losses based upon their judgment of information available to them at the time of their examination.

On a monthly basis, problem loans are identified and updated primarily using internally prepared past due reports. Based on data surrounding the collection process of each identified loan, the loan may be added or deleted from the monthly watch list. The watch list includes loans graded special mention, substandard, doubtful, and loss, as well as additional loans that management may choose to include. Watch list loans are continually monitored going forward until satisfactory conditions exist that allow management to upgrade and remove the loan from the watchlist. In certain cases, loans may be placed on non-accrual status or charged-off based upon management's evaluation of the borrower's ability to pay. All commercial loans, which include commercial real estate, agricultural real estate, state and political subdivision loans and commercial business loans, on non-accrual are evaluated quarterly for impairment.

The adequacy of the allowance for loan losses is subject to a formal, quarterly analysis by management of the Company. In order to better analyze the risks associated with the loan portfolio, the entire portfolio is divided into several categories. As stated above, loans on non-accrual status are specifically reviewed for impairment and given a specific reserve, if appropriate. Loans evaluated and not found to be impaired are included with other performing loans, by category, by their respective homogenous pools. Three year average historical loss factors were calculated for each pool and applied to the performing portion of the loan category for each year presented. The historical loss factors for both reviewed and homogeneous pools are adjusted based upon the following qualitative factors:

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

See also “Note 4 – Loans and Related Allowance for Loan Losses” to the consolidated financial statements.

The allowance for loan losses was $7,106,000 or 1.02% of total loans as of December 31, 2015 as compared to $6,815,000 or 1.23% of loans as of December 31, 2014. The $291,000 increase is a result of a $480,000 provision for loan losses less net charge-offs of $189,000. The decrease as a percent of loans is attributable to the increase in loans as part of the acquisition of FNB and the associated purchase accounting adjustments that were applied to the FNB loan portfolio. The following table shows the distribution of the allowance for loan losses and the percentage of loans compared to total loans by loan category (dollars in thousands) as of December 31:

	2015		2014		2013		2012		2011	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Residential	$ 905	29.3	$ 878	33.5	$ 946	34.6	$ 875	35.4	$ 805	37.7
Commercial, agricultural	3,785	42.5	3,870	38.9	4,558	39.8	4,437	38.8	4,132	37.9
Construction	24	2.2	26	1.1	50	1.7	38	2.4	15	1.7
Consumer	102	1.7	84	1.5	105	1.7	119	2.1	111	2.2
Other commercial and agricultural loans	1,305	10.2	1,224	10.6	942	10.0	728	9.5	674	9.1
State & political subdivision loans	593	14.1	545	14.4	330	12.2	271	11.8	235	11.4
Unallocated	392	N/A	188	N/A	167	N/A	316	N/A	515	N/A
Total allowance for loan losses	$ 7,106	100.0	$ 6,815	100.0	$ 7,098	100.0	$ 6,784	100.0	$ 6,487	100.0

As a result of previous loss experiences and other the risk factors utilized in determining the allowance, the Bank’s allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate loans total 42.5% of the loan portfolio, 53.3% of the allowance is assigned to this segment of the loan portfolio as these loans have more inherent risks than residential real estate or loans to state and political subdivisions. Residential real estate loans comprise 29.3% of the loan portfolio as of December 31, 2015 and 12.7% of the allowance is assigned to this segment as generally there are less inherent risks then commercial and agricultural loans.

The following table identifies amounts of loans contractually past due 30 to 90 days and non-performing loans by loan category, as well as the change from December 31, 2014 to December 31, 2015 in non-performing loans (dollars in thousands). Non-performing loans include those loans that are contractually past due 90 days or more and non-accrual loans. Interest does not accrue on non-accrual loans. Subsequent cash payments received are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of its ultimate ability to collect principal and interest.

December 31, 2015		December 31, 2014	
	Non-Performing Loans		Non-Performing Loans

	30 - 90 Days Past Due	90 Days Past Due Accruing	Non-accrual	Total Non-Performing	30 - 90 Days Past Due	90 Days Past Due Accruing	Non-accrual	Total Non-Performing
Real estate:								
Residential	$ 1,273	$ 394	$ 1,008	$ 1,402	$ 1,089	$ 346	$ 828	$ 1,174
Commercial	859	60	4,422	4,482	147	310	5,010	5,320
Agricultural	344	-	34	34	-	-	-	-
Construction	-	-	-	-	-	-	-	-
Consumer	262	9	55	64	75	6	47	53
Other commercial and agricultural loans	319	160	1,012	1,172	761	174	714	888
Total nonperforming loans	$ 3,057	$ 623	$ 6,531	$ 7,154	$ 2,072	$ 836	$ 6,599	$ 7,435

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	Change in Non-Performing Loans 2015 / 2014	
	Amount	%
Real estate:		
Residential	$ 228	19.4
Commercial	(838)	(15.8)
Agricultural	34	NA
Construction	-	-
Consumer	11	20.8
Other commercial and agricultural loans	284	32.0
Total nonperforming loans	$ (281)	(3.8)

The following table shows the distribution of non-performing loans by loan category (dollars in thousands) for the past five years as of December 31:

	Non-Performing Loans				
	2015	2014	2013	2012	2011
Real estate:					
Residential	$ 1,402	$ 1,174	$ 1,037	$ 995	$ 653
Commercial	4,482	5,320	7,591	7,194	8,270
Agricultural	34	-	-	-	-
Construction	-	-	-	-	-
Consumer	64	53	16	4	-
Other commercial and agricultural loans	1,172	888	150	380	517
State & political subdivision loans	-	-	-	-	-
Total nonperforming loans	7,154	7,435	8,794	8,573	9,440

For the year ended December 31, 2015, we recorded a provision for loan losses of $480,000 which compares to $585,000 for the same period in 2014, a decrease of $105,000. The decrease is primarily attributable to the decrease in net charged off loans during 2015 of $679,000. While charge-offs in 2014 were historically high for the Company, they were still low relative to peer and were primarily driven by two customers, which experienced charge-offs of $463,000 and $175,000. Additionally, it should be noted that non-performing loans decreased $281,000 or 3.78%, from December 31, 2014 to December 31, 2015. At December 31, 2015, approximately 59.4% of the Bank's non-performing loans are associated with the following three customer relationships:

- A commercial customer with a total loan relationship of $3.3 million secured by approximately 160 residential properties was on non-accrual status as of December 31, 2015. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. In July of 2013, the customer filed for bankruptcy under Chapter 11 and a Trustee was appointed in January of 2014. In 2015, the Trustee decreased the loan payments below what was agreed to in the forbearance agreement. This decrease is currently being litigated in bankruptcy court. As a result of the decrease, the relationship has become more than 90 days past due. In the second quarter of 2015, 25 appraisals were completed and management observed an additional 20 properties. The appraisals and observations did not note any significant change in collateral values. We continue to monitor the bankruptcy proceedings to identify potential changes in the customer's operations and the impact these would have on the loan payments for our loans to the customer and the underlying collateral that supports these loans. As of December 31, 2015, there is no specific reserve for this relationship.
- A commercial customer with a relationship of approximately $435,000 after a charge-off of $463,000 during the second quarter of 2014, secured by real estate was on non-accrual status as of December 31, 2015. The current economic conditions have significantly impacted the cash flows from the customer's activities. Management reviewed the collateral and in the second quarter of 2014 charged-off of a portion of the balance associated with this customer, which was based on the appraised value of collateral and as a result there is no specific reserve as of December 31, 2015.
- A commercial customer with a relationship of approximately $550,000 secured by real estate, equipment and accounts receivable was on non-accrual status as of December 31, 2015. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer. Management reviewed the collateral value and determined that a specific reserve of $125,000 was required as of December 31, 2015.

Management believes that the allowance for loan losses at December 31, 2015 was adequate at that date, which was based on the following factors:

- One loan relationship comprises 47.8% of the non-performing loan balance, whose debt was well collateralized as of December 31, 2015.
  - Net and gross charge-offs have returned to their low historical rate of .03% on an annualized basis in 2015.
- Real estate values in the Bank's primary market areas have only decreased slightly with the decrease in the market price for natural gas.

Bank Owned Life Insurance

The Company holds bank owned life insurance policies to offset future employee benefit costs. These policies provide the Bank with an asset that generates earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits. As of December 31, 2015 and 2014, the cash surrender value of the life insurance was $25.5 million and $20.3 million, respectively. The primary cause of the increase was related to the acquisition of FNB, which increased the balance by $4.6 million. The change in cash surrender value, net of purchases and amounts acquired through acquisitions, is recognized in the results of operations. The amounts recorded as non-interest income totaled $628,000, $507,000 and $502,000 in 2015, 2014 and 2013, respectively. The Company evaluates annually the risks associated with the life insurance policies, including limits on the amount of coverage and an evaluation of the various carriers' credit ratings.

Effective January 1, 2015, the Company restructured its agreements so that any death benefits received from a policy while the insured person is an active employee of the Bank will be split with the beneficiary of the policy. Under the restructured agreements, the employee's beneficiary will be entitled to receive 50% of the net amount at risk from the proceeds. The net amount at risk is the total death benefit payable less the cash surrender value of the policy as of the date of death. The policies acquired as part of the acquisition of FNB, provide a fixed dollar benefit for the beneficiaries estate, which is dependent on several factors including whether the covered individual was a Director of FNB or an employee of FNB and their salary level.

Other Assets

2015

Other assets increased $5.4 million in 2015 to $12.1 million from $6.7 million in 2014. As a result of the decrease in the market value of the Company's investment portfolio and the acquisition of FNB, net deferred taxes changed from a liability of $28,000 as of December 31, 2014 to an asset of $3.5 million as of December 31, 2015. As a result of the acquisition of FNB, regulatory stock increased $1.4 million.

2014

Other assets decreased $4.3 million in 2014 to $6.7 million from $11.0 million in 2013. As a result of the decrease in the market value of the Company's investment portfolio, net deferred taxes changed from an asset of $1,477,000 as of December 31, 2013 to a liability of $28,000. Due to actuarial changes in the pension plan, the funded status of the plan changed from an asset of $780,000 as of December 31, 2013 to a liability of $738,000. As a result of a decrease in FHLB borrowings regulatory stock decreased $1.9 million.

Deposits
The following table shows the breakdown of deposits by deposit type (dollars in thousands):

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	2015		2014		2013	
	Amount	%	Amount	%	Amount	%
Non-interest-bearing deposits	$ 150,960	15.3	$ 95,526	12.3	$ 85,585	11.4
NOW accounts	279,655	28.3	226,038	29.2	215,656	28.8
Savings deposits	170,277	17.2	108,252	14.0	95,678	12.8
Money market deposit accounts	105,229	10.7	95,350	12.3	85,038	11.4
Certificates of deposit	281,910	28.5	248,767	32.2	266,359	35.6
Total	$ 988,031	100.0	$ 773,933	100.0	$ 748,316	100.0

	2015/2014 Change		2014/2013 Change	
	Amount	%	Amount	%
Non-interest-bearing deposits	$ 55,434	58.0	$ 9,941	11.6
NOW accounts	53,617	23.7	10,382	4.8
Savings deposits	62,025	57.3	12,574	13.1
Money market deposit accounts	9,879	10.4	10,312	12.1
Certificates of deposit	33,143	13.3	(17,592)	(6.6)
Total	$ 214,098	27.7	$ 25,617	3.4

2015

Total deposits increased $214.1 million in 2015, or 27.7%. The primary driver of the increase was the acquisition of FNB, which resulted in an increase in deposits of $225.2 million. Excluding the acquisition, deposits decreased $11.1 million with the largest driver of the decrease being a decrease in public deposits. This was due to the fact that the Commonwealth of Pennsylvania had not passed a budget for the 2015-2016 fiscal year and as a result was not passing funds through to local public governments who maintain their deposit accounts with the Company. As a result, to fund operations, these entities were experiencing significant decreases in their deposit balances. In January, Pennsylvania did pass funds through to the entities to ease funding issues temporarily until a final budget is approved.

Excluding the acquisition, non-interest bearing deposits increased $6.9 million in 2015. As a percentage of total deposits, non-interest bearing deposits totaled 15.3% as of the end of 2015, which compares to 12.3% at the end of 2014 with the increase being driven by the acquisition of FNB. In order to manage our overall cost of funds, the Company continues to focus on adding low cost deposits by having several checking products available for retail customers as well as being the primary checking account for commercial customers who also have loans with the Company.

Excluding the acquisition, NOW accounts decreased by $16.4 million, money market deposit accounts decreased by $2.7 million and savings deposits increased $10.7 million since the end of 2014. The primary cause of the decrease in NOW accounts and money market accounts was the Pennsylvania budget stalemate described previously. The increase in savings accounts was primarily driven by our Wellsville office.
Excluding the impact of the acquisition, certificates of deposits decreased in 2015 by a total of $9.5 million. During 2015 the Company continued to pay historically low rates on certificates of deposits which are less attractive to the

Company's customers. Certain customers who typically utilize certificate of deposits as a means of generating income or as a longer term investment option, were moving funds into money market and savings accounts that still paid interest in order to maintain flexibility for potentially rising interest rates. The rates paid on certificates of deposit by the Company remain competitive with rates paid by our competition.

2014

Total deposits increased $25.6 million in 2014, or 3.4%. Non-interest bearing deposits increased $9.9 million, or 11.6% in 2014. As a percentage of total deposits, non-interest bearing deposits totaled 12.3% as of the end of 2014, which compared to 11.4% at the end of 2013.

NOW accounts increased by $10.4 million, or 4.8%, money market deposit accounts increased by $10.3 million or 12.1% and savings deposits decreased $12.6 million, or 13.1%, since the end of 2013. A portion of the increase in NOW accounts, money market accounts and savings deposits was offset by the decrease in certificates of deposits of $17.6 million from 2013 to 2014. The largest part of the remaining increase was attributable to Pennsylvania Act 13 impact fees paid to local governments, who have been impacted by the exploration activities for natural gas. As in 2013, during 2014 the Company continued to lower rates paid on certificates of deposits, including long term CD rates, which were less attractive to the Company's customers.
Remaining maturities of certificates of deposit of $100,000 or more are as follows (dollars in thousands):

	2015	2014	2013
3 months or less	$ 17,475	$ 13,036	$ 13,699
Over 3 months through 6 months	11,804	13,908	11,118
Over 6 months through 12 months	27,226	28,042	37,289
Over 12 months	69,875	57,211	55,836
Total	$ 126,380	$ 112,197	$ 117,942
As a percent of total certificates of deposit	44.83%	45.10%	44.28%

Interest expense on certificates of deposit of $100,000 or more amounted to $1,406,000, $1,379,000 and $1,516,000 for the years ended December 31, 2015, 2014, and 2013, respectively.

Deposits by type of depositor are as follows (dollars in thousands):

	2015		2014		2013	
	Amount	%	Amount	%	Amount	%
Individuals	$ 634,109	64.2	$ 468,595	60.5	$ 462,268	61.8
Businesses and other organizations	193,527	19.6	149,983	19.4	143,082	19.1
United States government	-	-	-	-	-	-
State & political subdivisions	160,395	16.2	155,355	20.1	142,966	19.1
Total	$ 988,031	100.0	$ 773,933	100.0	$ 748,316	100.0

Borrowed Funds

2015

Borrowed funds decreased $168,000 during 2015. The decrease was associated with a decrease of $15.0 million of short term borrowings from the FHLB, which was offset by an increase of $10.1 in repurchase agreements and a $4.7

million increase in long term borrowings. Term loans increased from $11.8 million as of December 31, 2014 to $16.5 million as of December 31, 2015 (see Note 9 of the consolidated financial statements for additional information). Due to the rate environment in 2015, and as a strategy to manage interest rate risk against the potential for rising rates in future years, the Company borrowed $4.7 million of long term loans at favorable rates. Management will continue to monitor interest rates and to minimize interest rate risk in future years may extend some of the short term borrowings via term notes. Short term borrowings from the FHLB were $1.6 million as of December 21, 2015 compared to $16.6 million as of December 31, 2014.

2014

Borrowed funds decreased $25.1 million during 2014, or 37.6%. The decrease was associated with a decrease of $26.4 million of short term borrowings from the FHLB and a decrease of $1.4 in repurchase agreements. Long term borrowings increased $2.6 million during 2014. Term loans increased from $9.2 million as of December 31, 2013 to $11.8 million as of December 31, 2014 (see Note 9 of the consolidated financial statements for additional information). Due to the rate environment in 2014, and as a strategy to manage interest rate risk against the potential for rising rates in future years, the Company borrowed $6.8 million of long term loans. Short term borrowings from the FHLB were $16.6 million as of December 21, 2014 compared to $43.0 million as of December 31, 2013.

Other Liabilities

2015

Other liabilities increased $4.8 million during 2015, or 59.7%. The primary driver of this increase was the acquisition of FNB, which resulted in an increase in pension liabilities of $2.3 million, other post-retirement benefits of $1.3 million and other liabilities of approximately $1.0 million.

2014

Other liabilities increased $1,297,000 during 2014, or 19.3%. The primary driver of this increase was due to actuarial changes in the pension plan in 2014, which resulted in the funded status of the pension plan changing from an asset of $780,000 as of December 31, 2013 to a liability of $738,000.

Stockholders' Equity

We evaluate stockholders' equity in relation to total assets and the risk associated with those assets. The greater our capital resources, the greater the likelihood of meeting our cash obligations and absorbing unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance. Due to its importance, we develop a capital plan and stress test capital levels using various techniques and assumptions annually to ensure that in the event of unforeseen circumstances, we would remain in compliance with our capital plan approved by the Board of Directors and regulatory requirement levels.

Our Board of Directors determines our dividend rate after considering our capital requirements, current and projected net income, and other factors. In 2015 and 2014, the Company paid out 46.0% and 49.3% of net income in dividends, respectively. The dividends paid in 2015 and 2014 included special dividends of $0.10 and $0.60 per share, respectively, which were paid in the third quarter of each year.

As of December 31, 2015, the total number of common shares outstanding was 3,335,875. As part of the acquisition of FNB, we issued 336,515 shares at a value of $47.50 per share. During 2015, we purchased 49,465 shares of treasury stock at a weighted average cost of $49.62 per share. The Company awarded 4,996 shares of restricted stock to employees and 1,206 shares to the Board of Directors under equity incentive programs.

For 2015, there are four federal regulatory measures of capital adequacy, which compares to three measures in 2014. The Company's ratios meet the regulatory standards for well capitalized for 2015 and 2014, as detailed in Note 14 of the consolidated financial statements.

2015

Stockholders' equity increased 19.1% in 2015 to $119.8 million. Excluding accumulated other comprehensive income, which is the after-tax effect of unrealized holding gains and losses on available-for-sale securities and additional pension obligation, stockholders' equity increased $20.2 million, or 20.3%. This increase is due to issuing 336,515 shares with a value of $16.0 million for the FNB acquisition, net income of $11.6 million, offset by net cash dividends of $5.2 million and the purchase of treasury stock of $2.5 million. All of the Company's investment securities are classified as available-for-sale, making this portion of the Company's balance sheet more sensitive to the changing market value of investments. Accumulated other comprehensive income (loss) decreased $1,003,000 from December 31, 2014 primarily as result of the decrease in the fair market value of the investment portfolio. Total equity was approximately 10.30% of total assets as of December 31, 2015, compared to 10.87% of total assets as of December 31, 2014.

2014

Stockholders' equity increased 9.2% in 2014 to $100.5 million from the end of 2013. Excluding accumulated other comprehensive income, stockholders' equity increased $6.5 million, or 7.0%. This increase was due to net income of $13,385,000, offset by net cash dividends of $6,121,000 and the purchase of treasury stock of $814,000. Accumulated other comprehensive income (loss) increased $1,992,000 from December 31, 2013 primarily as result of the increase in the fair market value of the investment portfolio. Total equity was approximately 10.87% of total assets as of December 31, 2014, compared to 10.06% of total assets as of December 31, 2013.

LIQUIDITY

Liquidity is a measure of the Company's ability to efficiently meet normal cash flow requirements of both borrowers and depositors. Liquidity is needed to meet depositors' withdrawal demands, extend credit to meet borrowers' needs, provide funds for normal operating expenses and cash dividends, and fund future capital expenditures.

To maintain proper liquidity, we use funds management policies along with our investment and asset liability policies to assure we can meet our financial obligations to depositors, credit customers and stockholders. Management monitors liquidity by reviewing loan demand, investment opportunities, deposit pricing and the cost and availability of borrowing funds. Additionally, the bank has established various limits and ratios to monitor liquidity. On a quarterly basis, we stress test our liquidity position to ensure that the Bank has the capability of meeting its cash flow requirements in the event of unforeseen circumstances. The Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows from investing and financing activities.

Cash generated by operating activities, investing activities and financing activities influences liquidity management. The most important source of funds is the deposits that are primarily core deposits (deposits from customers with other relationships). Short-term debt from the Federal Home Loan Bank supplements the Company's availability of funds as well as a line of credit arrangement with a corresponding bank. Other sources of short-term funds include brokered CDs and the sale of loans, if needed.

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is detailed. Other significant uses of funds are capital expenditures, purchase of loans and acquisition premiums. Surplus funds are then invested in investment securities.

Capital expenditures in 2015 totaled $776,000, which included:

Completion of the Mill Hall branch construction and equipment for the branch totaling $488,000
Signage for buildings acquired in the acquisition of $30,700
Computer and copier upgrades totaling $62,900
Bank vehicle replacement of $24,500
Card pinning machines for various branches totaling $27,200
ATM upgrades totaling $20,000

Capital expenditures in 2014 totaled $1,309,000, which included:

Construction of a new branch in the Mill Hall market totaling $1,113,000
Upgraded software totaling $42,600
Computer and copier upgrades totaling $29,400
Bank by phone system upgrade of $28,300

We expect these expenditures will allow us to support our growth initiatives over the next decade, create greater operating efficiency and provide the customer with higher quality banking services.

In addition, to the Bank's cash balances, the Bank achieves additional liquidity primarily from its investment in the FHLB of Pittsburgh and the resulting borrowing capacity obtained through this investment, investments that mature in less than one year and expected principal repayments from mortgage backed securities. The Bank has a maximum borrowing capacity at the Federal Home Loan Bank of approximately $254.3 million, inclusive of any outstanding amounts, as a source of liquidity. The Bank also has a federal funds line with a third party provider in the amount of $10.0 million as of December 31, 2015, which is unsecured and a borrower in custody agreement was established with

the FRB in the amount of $7.9 million, which is collateralized by $16.1 million of municipal loans.

The Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company is responsible for paying any dividends declared to its shareholders. The Company also has repurchased shares of its common stock. The Company's primary source of income is dividends received from the Bank. The Bank may not declare a dividend without approval of the FRB, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. In addition, the Bank can only pay dividends to the extent that its retained net profits (including the portion transferred to surplus) exceed its bad debts. The FRB, the OCC, the PDB and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At December 31, 2015, the Company (unconsolidated basis) had liquid assets of $4.6 million.

CONTRACTUAL OBLIGATIONS

The Company has various financial obligations, including contractual obligations which may require cash payments. The following table presents as of December 31, 2015, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the obligations can be found in Notes 8, 9 and 16 to the Consolidated Financial Statements.

Contractual Obligations	One year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Deposits without a stated maturity	$ 706,121	$ -	$ -	$ -	$ 706,121
Time deposits	128,954	99,848	43,355	9,753	281,910
FHLB Advances	1,598	-	-	-	1,598
Long-term borrowings - FHLB	-	3,000	2,000	11,525	16,525
Note Payable	7,500	-	-	-	7,500
Repurchase agreements	15,448	560	-	-	16,008
Operating leases	254	379	275	185	1,093
Total	$ 859,875	$ 103,787	$ 45,630	$ 21,463	$ 1,029,662

OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of operations, we engage in a variety of financial transactions that, in accordance with generally accepted accounting principles are not recorded in our financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customers' requests for funding and take the form of loan commitments, unused lines of credit and letters of credit. For

information about our loan commitments, unused lines of credit and letters of credit, see Note 15 of the notes to consolidated financial statements.

For the year ended December 31, 2015, we did not engage in any off-balance sheet transactions reasonably likely to have a material effect on our financial condition, results of operations or cash flows.

INTEREST RATE AND MARKET RISK MANAGEMENT

The objective of interest rate sensitivity management is to maintain an appropriate balance between the stable growth of income and the risks associated with maximizing income through interest sensitivity imbalances and the market value risk of assets and liabilities.

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk and, since the Company has no trading portfolio, it is not subject to trading risk.

At December 31, 2015, the Company had equity securities that represent only 0.7% of our investment portfolio, and therefore equity risk is not significant.

The primary factors that make assets interest-sensitive include adjustable-rate features on loans and investments, loan repayments, investment maturities and money market investments. The primary components of interest-sensitive liabilities include maturing certificates of deposit, IRA certificates of deposit, repurchase agreements and short-term borrowings. Savings deposits, NOW accounts and money market investor accounts, with the exception of top interest tier money market and NOW accounts, are considered core deposits and are not short-term interest sensitive and therefore are included in the table below in the over five year column. Top interest tier money market and NOW accounts are included in the table below in the within three month column.

The following table shows the cumulative static gap (at amortized cost) for various time intervals (dollars in thousands):

Maturity or Re-pricing of Company Assets and Liabilities as of December 31, 2015

	Within Three Months	Four to Twelve Months	One to Two Years	Two to Three Years	Three to Five Years	Over Five Years	Total
Interest-earning assets:							
Interest-bearing deposits at banks	$ 10,296	$ 742	$ 743	$ 2,480	$ 3,731	$ -	$ 17,992
Investment securities	10,326	41,184	88,860	78,412	122,093	13,523	354,398
Residential mortgage loans	32,136	48,470	45,384	32,019	32,923	12,475	203,407
Construction loans	2,284	7,466	5,261	-	-	-	15,011
Commercial and farm loans	133,705	53,744	55,758	56,234	53,248	13,881	366,570
Loans to state & political subdivisions	4,273.00	3,252	17,851	19,375	11,846	41,903	98,500
Other loans	2,512	2,639	2,416	1,360	951	1,665	11,543
Total interest-earning assets	$ 195,532	$ 157,497	$ 216,273	$ 189,880	$ 224,792	$ 83,447	$ 1,067,421
Interest-bearing liabilities:							
NOW accounts	$ 153,248	$ -	$ -	$ -	$ -	$ 126,407	$ 279,655
Savings accounts	-	-	-	-	-	170,277	170,277
Money Market accounts	89,830	-	-	-	-	15,399	105,229
Certificates of deposit	41,643	87,311	61,608	38,240	43,355	9,753	281,910
Short-term borrowing	16,512	-	-	-	-	-	16,512
Long-term borrowing	7,500	534	2,000	1,000	2,560	11,525	25,119
	$ 308,733	$ 87,845	$ 63,608	$ 39,240	$ 45,915	$ 333,361	$ 878,702

Total interest-bearing liabilities						
Excess interest-earning assets (liabilities)	$ (113,201)	$ 69,652	$ 152,665	$ 150,640	$ 178,877	$ (249,914)
Cumulative interest-earning assets	$ 195,532	$ 353,029	$ 569,302	$ 759,182	$ 983,974	$ 1,067,421
Cumulative interest-bearing liabilities	308,733	396,578	460,186	499,426	545,341	878,702
Cumulative gap	$ (113,201)	$ (43,549)	$ 109,116	$ 259,756	$ 438,633	$ 188,719
Cumulative interest rate sensitivity ratio (1)	0.63	0.89	1.24	1.52	1.80	1.21

(1) Cumulative interest-earning assets divided by interest-bearing liabilities.

The previous table and the simulation models discussed below are presented assuming money market investment accounts and NOW accounts in the top interest rate tier are re-priced within the first three months. The loan amounts reflect the principal balances expected to be re-priced as a result of contractual amortization and anticipated early payoffs.

Gap analysis, one of the methods used by us to analyze interest rate risk, does not necessarily show the precise impact of specific interest rate movements on the Bank's net interest income because the re-pricing of certain assets and liabilities is discretionary and is subject to competition and other pressures. In addition, assets and liabilities within the same period may, in fact, be repaid at different times and at different rate levels. We have not experienced the kind of earnings volatility that might be indicated from gap analysis.

The Bank currently uses a computer simulation model to better measure the impact of interest rate changes on net interest income. We use the model as part of our risk management and asset liability management processes that we believe will effectively identify, measure, and monitor the Bank's risk exposure. In this analysis, the Bank examines the results of movements in interest rates with additional assumptions made concerning the timing of interest rate changes, prepayment speeds on mortgage loans and mortgage securities. Shock scenarios, which assume a parallel shift in interest rates and is instantaneous, typically have the greatest impact on net interest income. The following is a rate shock analysis and the impact on net interest income as of December 31, 2015 (dollars in thousands):

Changes in Rates	Prospective One-Year Net Interest Income	Change In Prospective Net Interest Income	% Change In Prospective Net Interest Income
-100 Shock	$ 35,687	$ (799)	(2.19)
Base	36,486		
+100 Shock	35,989	(497)	(1.36)
+200 Shock	35,599	(887)	(2.43)
+300 Shock	35,026	(1,460)	(4.00)
+400 Shock	34,453	(2,033)	(5.57)

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage backed securities, call activity of other investment securities, and deposit selection, re-pricing and maturity structure. Because of these assumptions, actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change on net interest income. Additionally, the changes 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. The projections above utilize a static balance sheet and does not include any changes that may result from the growth of the Bank. Management has developed policy limits for acceptable changes in net interest income for multiple scenarios, including shock scenarios. As of December 31, 2015, changes in net interest income projected for all scenarios, including the shock scenarios noted above are in line with Bank policy limits for interest rate risk.

CRITICAL ACCOUNTING POLICIES

The Company's accounting policies are integral to understanding the results reported. The accounting policies are described in detail in Note 1 of the consolidated financial statements. Our most complex accounting policies require management's judgment to ascertain the valuation of assets, liabilities, commitments and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period.   In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

Other than Temporary Impairment

All securities are evaluated periodically to determine whether a decline in their value is other than temporary and is a matter of judgment. For debt securities, management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more-likely-than-not that it will not be required to sell the security, before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise,

the entire difference between fair value and amortized cost is charged to earnings. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an impairment loss unless sufficient evidence is available that the decline is not other than temporary and a recovery period can be predicted.

Allowance for Loan Losses

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. The Company's allowance for loan losses provides for probable losses based upon evaluations of known and inherent risks in the loan portfolio.

Management uses historical information to assess the adequacy of the allowance for loan losses as well as the prevailing business environment; as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. This evaluation is inherently subjective as it requires significant estimates that may be susceptible to significant change, subjecting the Bank to volatility of earnings. The allowance is increased by provisions for loan losses and by recoveries of loans previously charged-off and reduced by loans charged-off. For a full discussion of the Company's methodology of assessing the adequacy of the reserve for loan losses, refer to Note 1 of the consolidated financial statements.

Goodwill and Other Intangible Assets

As discussed in Note 1 of the consolidated financial statements, the Company must assess goodwill and other intangible assets each year for impairment. This assessment involves estimating the fair value of the Company's reporting units. If the fair value of the reporting unit is less than its carrying value including goodwill, we would be required to take a charge against earnings to write down the assets to the lower value.

Pension Benefits

Pension costs and liabilities are dependent on assumptions used in calculating such amounts. These assumptions include discount rates, benefits earned, interest costs, expected return on plan assets, mortality rates, and other factors. In accordance with GAAP, actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect recognized expense and the recorded obligation of future periods. While management believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the Company's pension obligations and future expense. Our pension benefits are described further in Note 10 of the "Notes to Consolidated Financial Statements."

Deferred Tax Assets

We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future income should prove non-existent or less than the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced. Management also evaluates deferred tax assets to determine if it is more likely than not that the deferred tax benefit will be utilized in future periods. If not, a valuation allowance is recorded. Our deferred tax assets are described further in Note 11 of the consolidated financial statements.

ITEM 7A – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

This information is included under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Interest Rate and Market Risk Management", appearing in this Annual Report on Form 10-K.

ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Citizens Financial Services, Inc.
Consolidated Balance Sheet

(in thousands, except share data)	December 31, 2015	2014
ASSETS:		
Cash and cash equivalents:		
Noninterest-bearing	$ 14,088	$ 10,091
Interest-bearing	10,296	1,332
Total cash and cash equivalents	24,384	11,423
Interest bearing time deposits with other banks	7,696	5,960
Available-for-sale securities	359,737	306,146
Loans held for sale	603	497
Loans (net of allowance for loan losses: 2015, $7,106; 2014, $6,815)	687,925	547,290
Premises and equipment	17,263	12,357
Accrued interest receivable	4,211	3,644
Goodwill	21,089	10,256
Bank owned life insurance	25,535	20,309
Other intangibles	2,437	473
Other assets	12,104	6,693
TOTAL ASSETS	$ 1,162,984	$ 925,048
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 150,960	$ 95,526
Interest-bearing	837,071	678,407
Total deposits	988,031	773,933
Borrowed funds	41,631	41,799
Accrued interest payable	734	756
Other liabilities	12,828	8,032
TOTAL LIABILITIES	1,043,224	824,520
STOCKHOLDERS' EQUITY:		
Preferred Stock $1.00 par value; authorized 3,000,000 shares 2015 and 2014; none issued in 2015 or 2014	-	-
Common Stock		
$1.00 par value; authorized 15,000,000 shares 2015 and 2014; issued 3,671,751 and 3,335,236 shares in 2015 and 2014, respectively	3,672	3,335
Additional paid-in capital	40,715	25,150
Retained earnings	85,790	79,512

Accumulated other comprehensive income (loss)		(236)		767
Treasury stock, at cost:				
335,876 and 296,280 shares for 2015 and 2014, respectively		(10,181)		(8,236)
TOTAL STOCKHOLDERS' EQUITY		119,760		100,528
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	1,162,984	$	925,048

See accompanying notes to consolidated financial statements.

Citizens Financial Services, Inc.
Consolidated Statement of Income
Year Ended December 31,

(in thousands, except share and per share data)	2015	2014	2013
INTEREST AND DIVIDEND INCOME:			
Interest and fees on loans	$ 29,039	$ 28,324	$ 28,982
Interest-bearing deposits with banks	142	82	40
Investment securities:			
Taxable	3,102	3,337	3,721
Nontaxable	3,152	3,354	3,405
Dividends	218	194	86
TOTAL INTEREST AND DIVIDEND INCOME			