CITIZENS FINANCIAL SERVICES INC
Form 10-K
March 08, 2018
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, 2017

or

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

For the transition period from to

Commission file number 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	(570) 662-2121

number, including area code

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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.:

Large accelerated filer
Accelerated filer
Non-accelerated filer
Smaller reporting company
(Do not check if a smaller reporting company)
Emerging growth company

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

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. $166,105,387 as of June 30, 2017.

As of February 26, 2018, there were 3,484,305 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 2018 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"), a Pennsylvania-chartered bank and trust company. 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. We completed the acquisition of a branch in Centre County, Pennsylvania on December 8, 2017. 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 added seven additional banking offices in south central Pennsylvania; four offices in Lebanon County, two offices in Schuylkill County, and one office in Berks County. During 2016, the Bank opened a full service branch in Lancaster County, Pennsylvania and a limited branch office in Union County, Pennsylvania. In 2017, the Bank opened a limited branch office in Lancaster County. We also purchased a full service branch in State College, Pennsylvania in 2017, which is located in Centre County, Pennsylvania. 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 north central, central and south central Pennsylvania, as well as the southern tier of New York. In addition to the main office in Mansfield, the Bank operates 25 full service offices and two limited branch office in its market areas.

As of December 31, 2017, the Bank had 233 full time employees and 40 part-time employees, resulting in 253 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. There has been an increase in competitive pressures as entities continue to seek loan growth and expand into new markets. In north central Pennsylvania there has been additional competition from brokerage firms and retirement fund management firms due to the wealth generated from the exploration for natural gas in the market area. 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 the 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 were 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, for banks with assets about $10.0 billion, was capped at $0.21 per transaction, plus an additional 5 basis point charge to cover fraud losses.

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.
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 regulator 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, 2017, 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.

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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 2017, without prior regulatory approval, aggregate dividends of approximately $13.9 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 acquisition and opening 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.

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 2018, the Bank is required to maintain average daily reserves equal to 3% on aggregate transaction accounts of up to and including $122.3 million, plus 10% on the remainder, and the first $16.0 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.

PROHIBITIONS AGAINST TYING ARRANGEMENTS

State-chartered banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

OTHER REGULATIONS

Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates. The Bank's operations are also subject to federal and state laws applicable to credit transactions, such as the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;
- Truth in Savings Act; and
- Rules and regulations of the various federal and state agencies charged with the responsibility of implementing such laws.

The Bank's operations also are subject to the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services;
- Check Clearing for the 21st Century Act (also known as "Check 21"), which gives "substitute checks," such as digital check images and copies made from that image, the same legal standing as the original paper check;
- The USA PATRIOT Act, which requires banks operating to, among other things, establish broadened anti-money laundering compliance programs, due diligence policies and controls to ensure the detection and reporting of money laundering. Such required compliance programs are intended to supplement existing compliance requirements, also applicable to financial institutions, under the Bank Secrecy Act and the Office of Foreign Assets Control regulations; and

- The Gramm-Leach-Bliley Act, which places limitations on the sharing of consumer financial information by financial institutions with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution's privacy policy and provide such customers the opportunity to "opt out" of the sharing of certain personal financial information with unaffiliated third parties.

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 is also 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.

ACQUISITION OF THE HOLDING COMPANY

Under the Change in Bank Control Act (the "CIBCA"), a federal statute, 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.

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.

Activities related to the drilling for natural gas in the in the Marcellus and Utica Shale formations impacts certain customers of the Bank.

Our north central Pennsylvania 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 is influenced by the natural gas industry. Loan demand, deposit levels and the market value of local real estate are 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 are impacted by changes in 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 or loan collateral values. 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 $11.2 million, or 1.12% of total loans outstanding and 104.3% of nonperforming loans, at December 31, 2017. Our allowance for loan losses at December 31, 2017 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, 2017 we had a total of 39 loan relationships with outstanding balances that exceeded $3.0 million, 38 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.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments, which changes the impairment model for most financial assets. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. The implementation of this standard may result in significant changes to the balance in the allowance for loan losses and may results in significant costs being expended to implement.

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

At December 31, 2017, we had $308.1 million in loans secured by commercial real estate, $240.0 million in agricultural real estate loans, $13.5 million in construction loans and $104.7 million in municipal loans. Commercial real estate loans, agricultural real estate, construction and municipal loans represented 30.8%, 24.0%, 1.3% and 10.5%, respectively, of our loan portfolio. At December 31, 2017, we had $7.8 million of reserves specifically allocated to these loan types. While commercial real estate, agricultural real estate, 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. We monitor loan concentrations on an individual relationship and industry wide basis to monitor the amount of risk we have in our loan portfolio.

Agricultural loans are dependent for repayment on the successful operation and management of the farm property, the health of the agricultural industry broadly, and on the location of the borrower in particular, and other factors outside of the borrower's control.

At December 31, 2017, our agricultural loans, consisting primarily of agricultural real estate loans and other agricultural loans were $277.8 million representing 27.8% of our total loan portfolio. The primary activities of our agricultural customers include dairy and beef farms, poultry and swine operations, crops and support businesses. Agricultural markets are highly sensitive to real and perceived changes in the supply and demand of agricultural products. Weaker prices, could reduce the value of agricultural land in our local markets and thereby increase the risk of default by our borrowers or reduce the foreclosure value of agricultural land, animals and equipment that serves as collateral for certain of our loans. At December 31, 2017, the Company had a loan concentration to the dairy industry as loans to this industry totaled $137,502,000, or 13.7% of total loans.

Our agricultural loans are dependent on the profitable operation and management of the farm property securing the loan and its cash flows. The success of a farm property may be affected by many factors outside the control of the borrower, including:

- adverse weather conditions (such as hail, drought and floods), restrictions on water supply or other conditions that prevent the planting of a crop or limit crop yields;
- loss of crops or livestock due to disease or other factors;
- declines in the market prices or demand for agricultural products (both domestically and internationally), for any reason;
- increases in production costs (such as the costs of labor, rent, feed, fuel and fertilizer);
- the impact of government policies and regulations (including changes in price supports, subsidies, government-sponsored crop insurance, minimum ethanol content requirements for gasoline, tariffs, trade barriers and health and environmental regulations);
- access to technology and the successful implementation of production technologies; and
- changes in the general economy that could affect the availability of off-farm sources of income and prices of real estate for borrowers.

Lower prices for agricultural products may cause farm revenues to decline and farm operators may be unable to reduce expenses as quickly as their revenues decline. In addition, many farms are dependent on a limited number of key individuals whose injury or death could significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower's ability to repay the loan may be impaired. Consequently, agricultural loans may involve a greater degree of risk than residential mortgage lending, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets such as farm equipment (some of which is highly specialized with a limited or no market for resale) or perishable assets such as livestock or crops. In such cases, any repossessed collateral for a defaulted agricultural operating loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation or because the assessed value of the collateral exceeds the eventual realization value.

Loan participations comprise a significant portion of our loan portfolio and a decline in loan participation volume could hurt profits and slow loan growth.

We have actively engaged in loan participations 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 totaled $84.7 million, $86.7 million and $86.3 million at December 31, 2017, 2016 and 2015, respectively. As a percent of total loans, participation purchased loans were 8.5%, 10.8% and 12.4% as of December 31, 2017, 2016 and 2015. 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, 2017, our investment portfolio included available for sale investment securities with an amortized cost of $255.1 million and a fair value of $254.9 million, which included unrealized losses on 122 securities totaling $1,288,000. 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.

Our profits, asset values and liquidity could be hurt if the Pennsylvania state legislature and governor fail to pass a state budget.

The Company makes loans to, invests in securities issued by, and maintains deposit accounts of Pennsylvania municipalities, primarily school districts. If a budget impasse occurs, 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. A 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. 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 $28,329,000 at December 31, 2017. The FHLB maintains a first-loss position for the MPF portfolio that totals $123,000. Should the FHLB exhaust its first-loss position, recourse to the Bank's credit enhancement would be up to the next $980,000 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, Lebanon, Schuylkill, Berks and Lancaster in south central, Pennsylvania and Allegany, Steuben, Chemung and Tioga Counties in southern New York. With the acquisition of the State College branch in December 2017, we consider Centre County to be a primary market going forward. As of December 31, 2017, management estimates that approximately 90.1% of deposits and 64.5% of loans came from households whose primary address is located in the Bank's primary market areas. 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 areas. 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 uneven, and while the unemployment rate has decreased, the percentage of people out of the workforce remains elevated. A return to prolonged deteriorating economic conditions and/or 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 entering new markets.

With the FNB acquisition in 2015, the hiring of additional agricultural lending teams in 2016 and the State College branch acquisition in 2017, the Company entered into new banking market areas. The success of entering these new markets 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 the acquisition, as well as organically growing loans and deposits. To realize these anticipated benefits and cost savings, the businesses and individuals 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 and the new employee hiring's, the Company's results of operations could be adversely affected.

Regulation of the financial services industry is undergoing major changes, and future legislation could increase our 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.

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 composition of our assets or liabilities, to assess civil monetary penalties against us and/or 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, 2017, which is the most recent date for which information is available, we held 35.7% 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 6.2% 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, 2017, we held 7.1% of the deposits in Lebanon County, Pennsylvania, which was the fifth largest share out of the 12 financial institutions with offices in the County. 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 and agricultural loan officers. The unexpected loss of services of any key management personnel or commercial and agricultural 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.

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.

Impairment of goodwill could require charges to earnings, which could result in a negative impact on our results of operations.

Our goodwill could become impaired in the future. If goodwill were to become impaired, it could limit the ability of the Bank to pay dividends to the Company, adversely impacting the Company's liquidity and ability to pay dividends. The most significant assumptions affecting our goodwill impairment evaluation are variables including the market price of our Common Stock, projections of earnings, and the control premium above our current stock price that an acquirer would pay to obtain control of us. We are required to test goodwill for impairment at least annually or when impairment indicators are present. If an impairment determination is made in a future reporting period, our earnings and book value of goodwill will be reduced by the amount of the impairment. If an impairment loss is recorded, it will have little or no impact on the tangible book value of our Common Stock, or our regulatory capital levels, but such an impairment loss could significantly reduce the Bank's earnings and thereby restrict the Bank's ability to make dividend payments to us without prior regulatory approval, because Federal Reserve policy states the bank holding company dividends should be paid from current earnings. At December 31, 2017, the book value of our goodwill was $23.3 million, all of which was recorded at the Bank.

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 two banking facilities and leases seven 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 $15,603,000 as of December 31, 2017. 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. For 2017 and 2016, cash dividends were declared on a quarterly basis and are summarized in the table below:

	2017 High	Low	Dividends declared per share	2016 High	Low	Dividends declared per share
First quarter	$50.29	$48.29	$ 0.425	$48.51	$46.78	$ 0.415
Second quarter	53.50	50.10	0.425	48.50	46.53	0.415
Third quarter	57.00	52.65	0.430	52.00	47.25	0.420
Fourth quarter	62.51	57.05	0.430	51.75	49.50	0.420

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 distribution. 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 Matters" to the consolidated financial statements.

As of February 26, 2018, the Company had approximately 1,766 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, 2017:

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)
10/1/17 to 10/31/17	-	$ 0.00	-	94,976
11/1/17 to 11/30/17	451	$ 59.37	451	94,525
12/1/17 to 12/31/17	5,086	$ 60.27	5,086	89,439
Total	5,537	$ 60.20	5,537	89,439

(1) 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.

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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, SNL Bank $1 Billion to $5 Billion 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, 2010 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 of 2015 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 Ended							
Index	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Citizens Financial Services, Inc.	100	97.16	127.15	171.89	179.56	169.90	191.94	245.23
S&P 500	100	102.11	118.45	156.82	178.28	180.75	202.37	246.55
SNL Mid-Atlantic Bank	100	75.13	100.64	135.65	147.79	153.33	194.89	238.86
SNL Bank $1B-$5B	100	91.2	112.45	163.52	170.98	191.39	275.35	293.55
SNL Bank $500M-$1B	100	87.98	112.79	146.26	160.46	181.11	244.54	298.34

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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, 2017:

(in thousands, except per share data)	2017		2016		2015		2014		2013	
Interest and dividend income	$48,093		$43,005		$35,653		$35,291		$36,234	
Interest expense	5,839		5,041		4,820		4,953		6,315	
Net interest income	42,254		37,964		30,833		30,338		29,919	
Provision for loan losses	2,540		1,520		480		585		405	
Net interest income after provision for loan losses	39,714		36,444		30,353		29,753		29,514	
Non-interest income	7,621		7,644		6,994		6,740		6,982	
Investment securities gains (losses), net	1,035		255		429		616		441	
Non-interest expenses	29,314		28,671		23,429		20,165		19,810	
Income before provision for income taxes	19,056		15,672		14,347		16,944		17,127	
Provision for income taxes	6,031		3,034		2,721		3,559		3,752	
Net income	$13,025		$12,638		$11,626		$13,385		$13,375	
Per share data:										
Net income - Basic (1)	$3.74		$3.60		$3.60		$4.14		$4.11	
Net income - Diluted (1)	3.74		3.60		3.60		4.13		4.11	
Cash dividends declared (1)	1.67		1.58		1.63		2.04		1.14	
Stock dividend	5	%	1	%	0	%	1	%	5	%
Book value (1) (2)	37.81		35.77		33.95		30.82		28.76	
End of Period Balances:										
Total assets	$1,361,886		$1,223,018		$1,162,984		$925,048		$914,934	
Total investments	254,782		314,017		359,737		306,146		317,301	
Loans	1,000,525		799,611		695,031		554,105		540,612	
Allowance for loan losses	11,190		8,886		7,106		6,815		7,098	
Total deposits	1,104,943		1,005,503		988,031		773,933		748,316	
Total borrowed funds	114,664		79,662		41,631		41,799		66,932	
Stockholders' equity	129,011		123,268		119,760		100,528		92,056	
Key Ratios:										
Return on assets (net income to average total assets)	1.03	%	1.06	%	1.22	%	1.48	%	1.51	%
Return on equity (net income to average total equity)	10.04	%	10.24	%	11.20	%	13.73	%	14.89	%
Equity to asset ratio (average equity to average total assets, excluding other comprehensive income)	10.31	%	10.35	%	10.91	%	10.74	%	10.13	%
Net interest margin	3.80	%	3.68	%	3.76	%	3.84	%	3.87	%
Efficiency (3)	54.82	%	57.97	%	54.50	%	48.61	%	48.12	%
Dividend payout ratio (dividends declared divided by net income)	44.97	%	44.12	%	46.00	%	49.32	%	27.63	%
Tier 1 leverage	9.18	%	9.46	%	11.01	%	10.99	%	10.42	%
Common equity risk based capital	11.27	%	12.89	%	14.14	%	N/A		N/A	
Tier 1 risk-based capital	12.04	%	13.81	%	15.20	%	17.30	%	16.44	%
Total risk-based capital	13.21	%	14.93	%	16.23	%	18.55	%	17.75	%
Nonperforming assets/total loans	1.18	%	1.61	%	1.22	%	1.67	%	1.88	%
Nonperforming loans/total loans	1.07	%	1.48	%	1.03	%	1.34	%	1.63	%

Allowance for loan losses/total loans	1.12 %	1.11 %	1.02 %	1.23 %	1.31 %
Net charge-offs (recoveries)/average loans	0.03 %	(0.04 %)	0.03 %	0.16 %	0.02 %

(1) Amounts were adjusted to reflect stock dividends.
(2) Calculation excludes accumulated other comprehensive income.
(3) Bank expenses to tax adjusted net interest income and non-interest income excluding security gains

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, including expansions, 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, regulatory or compliance practices or requirements. Failure to comply with any one or more of these requirements could have an adverse effect on our operations.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition.
- We could 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.
- Loan concentrations in certain industries could negatively impact our results, if financial results or economic conditions deteriorate.
- A budget impasse in the Commonwealth of Pennsylvania could impact our asset values, liquidity and profitability as a result of either delayed or reduced funding to school districts and municipalities who are customers of the bank.
- 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 the accompanying consolidated financial statements for the Company. The 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.

The Company currently engages in the general business of banking throughout our service area of Potter, Tioga, Clinton, Potter and Centre counties in north central Pennsylvania, Lebanon, Berks, Schuylkill and Lancaster counties in south central Pennsylvania and Allegany county in southern New York. We also have a limited branch office in Union county, Pennsylvania, which primarily serves agricultural customers in the central Pennsylvania market. We maintain our main office in Mansfield, Pennsylvania. Presently we operate 29 banking facilities, 28 of which operate as bank branches. In Pennsylvania, the Company has full service offices located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Mansfield Wal-Mart Super Center, Mill Hall, Schuylkill Haven, Friedensburg, Mt. Aetna, Fredericksburg, Mount Joy, State College and three branches near the city of Lebanon, Pennsylvania. We also have limited branch offices in Winfield and Narvon, 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.

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, 2017 and 2016, assets owned and invested by customers of the Bank through the Bank's investment representatives totaled $156.0 million and $137.4 million, respectively. Additionally, as summarized in the table below, the Trust Department had assets under management as of December 31, 2017 and 2016 of $122.7 million and $110.6 million, respectively. The increase in assets under management is due to due to new accounts and contributions of $7.5 million, accounts closings and distributions of $7.2 million and changes in market value and income of $11.8 million.

(market values - in thousands)	2017	2016
INVESTMENTS:		
Bonds	$18,672	$17,871
Stock	18,957	18,860
Savings and Money Market Funds	13,076	10,697
Mutual Funds	67,027	59,306
Mineral interests	3,885	2,598
Mortgages	343	456
Real Estate	513	613
Miscellaneous	238	170
Cash	9	-
TOTAL	$122,720	$110,571
ACCOUNTS:		
Trusts	28,714	26,597
Guardianships	748	1,846
Employee Benefits	57,035	48,692
Investment Management	36,221	33,434
Custodial	2	2
TOTAL	$122,720	$110,571

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 traditional trust and investment services offered, we assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. As of December 31, 2017, customers owning 7,012 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, 2017 was $13,025,000, which represents an increase of $387,000, or 3.1%, when compared to the 2016 related period. Net income for the year ended December 31, 2016 was $12,638,000, which represents an increase of $1,012,000, or 8.7%, when compared to the 2015 related period. Basic and diluted earnings per share were $3.74, $3.60, and $3.60 for the years ended 2017, 2016 and 2015, 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 2017 were slightly impacted by the acquisition of the State College branch, which closed on December 8, 2017. The average balances and rates for 2016 were impacted by the acquisition of FNB, which closed on December 11, 2015. The FNB acquisition had a small impact on average balances for 2015:

Analysis of Average Balances and Interest Rates

	2017			2016			2015		
	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	8,790	15	0.17	22,726	82	0.36	12,218	20	0.16
Total short-term investments	8,790	15	0.17	22,726	82	0.36	12,218	20	0.16
Interest bearing time deposits at banks	8,346	171	2.05	7,232	139	1.92	6,215	122	1.97
Investment securities:									
Taxable	194,716	3,366	1.73	254,673	3,971	1.56	202,991	3,320	1.64
Tax-exempt (3)	84,235	3,657	4.34	99,689	4,499	4.51	97,852	4,776	4.88
Total investment securities	278,951	7,023	2.52	354,362	8,470	2.39	300,843	8,096	2.69
Loans:									
Residential mortgage loans	206,321	10,660	5.17	204,278	10,749	5.26	182,877	10,059	5.50
Construction loans	24,299	1,040	4.28	15,242	752	4.93	8,518	438	5.14
Commercial Loans	329,767	17,525	5.31	302,717	16,163	5.34	248,754	12,969	5.21
Agricultural Loans	214,200	9,251	4.32	91,279	4,374	4.79	43,764	2,325	5.31
Loans to state & political subdivisions	98,427	4,146	4.21	101,329	4,278	4.22	85,631	3,815	4.45
Other loans	10,341	823	7.96	11,036	916	8.30	8,448	676	8.00
Loans, net of discount (2)(3)(4)	883,355	43,445	4.92	725,881	37,232	5.13	577,992	30,282	5.24
Total interest-earning assets	1,179,442	50,654	4.29	1,110,201	45,923	4.14	897,268	38,520	4.29
Cash and due from banks	6,774			7,357			4,197		
Bank premises and equipment	16,799			17,218			12,837		
Other assets	55,910			57,604			36,781		
Total non-interest earning assets	79,483			82,179			53,815		
Total assets	1,258,925			1,192,380			951,083		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									
NOW accounts	323,105	1,139	0.35	301,681	917	0.30	230,675	801	0.35
Savings accounts	179,557	191	0.11	172,182	184	0.11	119,021	144	0.12
Money market accounts	127,888	650	0.51	118,486	523	0.44	98,452	481	0.49
Certificates of deposit	261,758	2,645	1.01	271,117	2,623	0.97	250,952	2,687	1.07
	892,308	4,625	0.52	863,466	4,247	0.49	699,100	4,113	0.59

Total interest-bearing deposits									
Other borrowed funds	68,536	1,214	1.77	47,004	794	1.69	36,700	707	1.93
Total interest-bearing liabilities	960,844	5,839	0.61	910,470	5,041	0.55	735,800	4,820	0.66
Demand deposits	153,523			145,968			102,977		
Other liabilities	14,802			12,524			8,510		
Total non-interest-bearing liabilities	168,325			158,492			111,487		
Stockholders' equity	129,756			123,418			103,796		
Total liabilities & stockholders' equity	1,258,925			1,192,380			951,083		
Net interest income		44,815			40,882			33,700	
Net interest spread (5)			3.68 %			3.59 %			3.63 %
Net interest income as a percentage of average interest-earning assets			3.80 %			3.68 %			3.76 %
Ratio of interest-earning assets to interest-bearing liabilities			1.23			1.22			1.22

(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.

Tax exempt interest revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%, which is the Bank's federal income tax rate for 2017, 2016 and 2015.
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, 2017, 2016 and 2015, respectively (in thousands):

	2017	2016	2015
Interest and dividend income from investment securities, interest bearing time deposits and short-term investments (non-tax adjusted)	$5,966	$7,161	$6,614
Tax equivalent adjustment	1,243	1,530	1,624
Interest and dividend income from investment securities, interest bearing time deposits and short-term investments (tax equivalent basis)	$7,209	$8,691	$8,238

	2017	2016	2015
Interest and fees on loans (non-tax adjusted)	$42,127	$35,844	$29,039
Tax equivalent adjustment	1,318	1,388	1,243
Interest and fees on loans (tax equivalent basis)	$43,445	$37,232	$30,282

	2017	2016	2015
Total interest income	$48,093	$43,005	$35,653
Total interest expense	5,839	5,041	4,820
Net interest income	42,254	37,964	30,833
Total tax equivalent adjustment	2,561	2,918	2,867
Net interest income (tax equivalent basis)	$44,815	$40,882	$33,700

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

	2017 vs. 2016 (1)			2016 vs. 2015 (1)		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
Interest Income:						
Interest-bearing deposits at banks	$(36)	$(31)	$(67)	$26	$36	$62
Interest bearing time deposits at banks	23	9	32	20	(3)	17
Investment securities:						
Taxable	(1,121)	516	(605)	797	(146)	651
Tax-exempt	(677)	(165)	(842)	92	(369)	(277)
Total investment securities	(1,798)	351	(1,447)	889	(515)	374
Total investment income	(1,811)	329	(1,482)	935	(482)	453
Loans:						
Residential mortgage loans	110	(199)	(89)	1,096	(406)	690
Construction loans	371	(83)	288	331	(17)	314
Commercial Loans	1,437	(75)	1,362	2,875	319	3,194
Agricultural Loans	5,263	(386)	4,877	2,252	(203)	2,049
Loans to state & political subdivisions	(122)	(10)	(132)	648	(185)	463
Other loans	(56)	(37)	(93)	214	26	240
Total loans, net of discount	7,003	(790)	6,213	7,416	(466)	6,950
Total Interest Income	5,192	(461)	4,731	8,351	(948)	7,403
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	69	153	222	195	(79)	116
Savings accounts	8	(1)	7	54	(14)	40
Money Market accounts	44	83	127	79	(37)	42
Certificates of deposit	(78)	100	22	321	(385)	(64)
Total interest-bearing deposits	43	335	378	649	(515)	134
Other borrowed funds	379	41	420	156	(69)	87

Total interest expense	422	376	798	805	(584)	221
Change in net interest income	$4,770	$ (837)	$3,933	$7,546	$ (364)	$7,182

(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.
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2017 vs. 2016

Tax equivalent net interest income for 2017 was $44,815,000 compared to $40,882,000 for 2016, an increase of $3,933,000 or 9.6%. Total interest income increased $4,731,000, as loan interest income increased $6,213,000, while total investment income decreased $1,482,000. Interest expense increased $798,000 from 2016.

Total tax equivalent interest income from investment securities decreased $1,447,000 in 2017 from 2016. The average balance of investment securities decreased $75.4 million, which had an effect of decreasing interest income by $1,798,000 due to volume. The majority of the decrease in volume was in taxable securities, which experienced a decrease in the average balance of $60.0 million. The average tax-effected yield on our investment portfolio increased from 2.39% in 2016 to 2.52% in 2017. This had the effect of increasing interest income by $351,000 due to rate, which was related to taxable securities whose yield increased from 1.56% in 2016 to 1.73% in 2017. The primary driver of the decrease in the average balance of investments securities is attributable to the decision to fund a portion of our strong loan growth through the cashflows of the investment portfolio. The increase in yield is attributable to the Federal Reserve raising interest rates during 2017. Investment purchases in 2017 focused on securities with short fixed maturities for agency securities and short repricing windows for asset backed securities. We also focused our purchases on securities with lower risk weightings due to the loan growth experienced that carries a higher risk weight for capital adequacy purposes. We continually monitor interest rate trading ranges and try to focus purchases to times when rates are in the top third of the trading range. The Bank believes its investment strategy has appropriately mitigated its interest rate risk exposure if rates continue to rise, while providing sufficient cashflows.

In total, loan interest income increased $6,213,000 in 2017 from 2016. The average balance of our loan portfolio increased by $157.5 million in 2017 compared to 2016, which resulted in an increase in interest income of $7,003,000 due to volume. Offsetting this was a decrease in average yield on total loans from 5.13% in 2016 to 4.92% in 2017 resulting in a decrease in interest income of $790,000 due to rate. The increase in the average balance of loans was driven by the loan growth in our central and south central Pennsylvania markets as a result of lending teams hired in 2016.

- Interest income on residential mortgage loans decreased $89,000. The average balance of residential mortgage loans increased $2.0 million, resulting in an increase of $110,000 due to volume. The change due to rate was a decrease of $199,000 as the average yield on residential mortgages decreased from 5.26% in 2016 to 5.17% in 2017.
- The average balance of construction loans increased $9.1 million from 2016 to 2017, due to several large projects in progress during 2017 which resulted in an increase of $371,000 in interest income. Additionally, the average yield on construction loans decreased from 4.93% to 4.28%, which correlated to a $83,000 decrease in interest income.
- Interest income on commercial loans increased $1,362,000 from 2016 to 2017. The increase in the average balance of commercial loans of $27.1 million is primarily attributable to the additional lenders hired in 2016 to serve the central and south central markets. The ability of these lenders to attract and retain previous loan relationships, and the market upheaval created by several bank mergers in the Lebanon and Lancaster markets, resulted in commercial loan growth. The increase in the average balance of these loans resulted in an increase in interest income due to volume of $1,437,000. 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 Small Business Administration (SBA) guaranteed loan programs to offset risk and to further promote economic growth in our market area.

- Interest income on agricultural loans increased $4,877,000 from 2016 to 2017. The increase in the average balance of agricultural loans of $122.9 million is primarily attributable to the additional lenders hired in 2016 to serve the central and south central markets. The market disruption discussed above resulted in agricultural loan growth in the Lancaster and Lebanon markets. The increase in the average balance of these loans resulted in an increase in interest income due to volume of $5,263,000. The average yield on agricultural loans decreased from 4.79% in 2016 to 4.32% in 2017 resulting in a decrease in interest income due to rate of $386,000. 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) guaranteed loan programs to offset risk and to further promote economic growth in our market area.
- The average balance of loans to state and political subdivisions decreased $2.9 million from 2016 to 2017 which had a negative impact of $122,000 on total interest income due to volume. The average tax equivalent yield on loans to state and political subdivisions decreased from 4.22% in 2016 to 4.21% in 2017, decreasing interest income by $10,000.

Total interest expense increased $798,000 in 2017 compared to 2016. A portion of the increase is attributable to a change in volume as the average balance of interest bearing liabilities increased $50.4 million in 2017, which had the effect of increasing interest expense by $422,000. This increase was attributable to growth necessary to fund the loan growth experienced by the Bank. Increases in average deposits included NOW accounts of $21.4 million, savings accounts of $7.4 million and money markets accounts of $9.4. The combined impact to interest expense of these increases was an increase $121,000. The average balance of other borrowed funds increased $21.5 million as a result of funding loan growth, which corresponds to an increase in interest expense of $3789,000. The average balance of certificates of deposits decreased $9.4 million, which corresponds to a decrease in interest expense of $78,000.
The average interest rate paid on interest bearing liabilities increased from 0.55% in 2016 to 0.61% in 2017, which resulted in an increase in interest expense of $376,000. The Federal Reserve raised short term rates during 2017, but long term rates experienced little change. The average rate on certificates of deposit increased from 0.97% to 1.01% resulting in an increase in interest expense of $100,000. The average rate paid on other borrowed funds increased from 1.69% to 1.77% resulting in an increase in interest expense of $41,000. Increases in rates paid on NOW accounts, savings accounts and money market accounts were less than 7 basis points, and resulted in a cumulative increase in interest expense of $235,000.
Our net interest margin for 2017 was 3.80% compared to 3.68% for 2016. The interest rate environment for the majority of 2017 was a flat yield curve with short term rates rising, while longer term rates remained steady. Should short or long-term interest rates move in such a way that results in a further flattening or inverted yield curve, we would anticipate additional pressure on our margin.

2016 vs. 2015
Tax equivalent net interest income for 2016 was $40,882,000 compared to $33,700,000 for 2015, an increase of $7,182,000 or 21.3%. Total interest income increased $7,403,000, as loan interest income increased $6,950,000, while total investment income increased $453,000. Interest expense increased $221,000 from 2015.
Total tax equivalent interest income from investment securities increased $374,000 in 2016 from 2015. The average balance of investment securities increased $53.5 million, which had an effect of increasing interest income by $889,000 due to volume. The majority of the increase in volume was in taxable securities, which experienced an increase in the average balance of $51.7 million. The average tax-effected yield on our investment portfolio decreased from 2.69% in 2015 to 2.39% in 2016. This had the effect of decreasing interest income by $515,000 due to rate, the majority of which was related to non-taxable securities whose yield decreased from 4.88% in 2015 to 4.51% in 2016. The primary driver of the increase in the average balance of investments securities was attributable to the FNB acquisition. The decrease in yield was also attributable to the acquisition of FNB, as the securities acquired had a lower yield than our existing portfolio. Due to the amount of liquidity obtained as part of the FNB acquisition, during the first part of 2016 purchases made included US agency securities, mortgage backed securities, and high coupon municipal bonds. During the second half of 2016, 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.

In total, loan interest income increased $6,950,000 in 2016 from 2015. The average balance of the loan portfolio increased by $147.9 million in 2016 compared to 2015, which resulted in an increase in interest income of $7,416,000 due to volume. Offsetting this was a decrease in average yield on total loans from 5.24% in 2015 to 5.13% in 2016 resulting in a decrease in interest income of $466,000 due to rate. The increase in the average balance of loans was driven by the FNB acquisition as well as loan growth in our central and south central Pennsylvania markets as a result of lending teams hired in 2016.

- Interest income on residential mortgage loans increased $690,000. The average balance of residential mortgage loans increased $21.4 million, resulting in an increase of $1,096,000 due to volume. The increase in volume was a result of the FNB acquisition. The change due to rate was a decrease of $406,000 as the average yield on residential mortgages decreased from 5.50% in 2015 to 5.26% in 2016. The Bank originated loans to be sold of $22.2 million during 2016, which compares to $18.9 million originated in 2015.
- The average balance of construction loans increased $6.7 million from 2015 to 2016, due to several large projects in progress during 2016 which resulted in an increase of $331,000 in interest income. Additionally, the average yield on construction loans decreased from 5.14% to 4.93%, which correlated to a $17,000 decrease in interest income.
- Interest income on commercial loans increased $3,194,000 from 2015 to 2016. The increase in the average balance of commercial loans of $54.0 million is primarily attributable to the acquisition of FNB. The increase in the average balance of these loans resulted in an increase in interest income due to volume of $2,875,000. The average rate on commercial loans increased 13 basis points to 5.34% in 2016, resulting in an increase in income of $319,000.
- Interest income on agricultural loans increased $2,049,000 from 2015 to 2016. The increase in the average balance of agricultural loans of $47.5 million is primarily attributable to the additional lenders hired in 2016 to serve the central and south central markets. The increase in the average balance of these loans resulted in an increase in interest income due to volume of $2,252,000. The average yield on agricultural loans decreased from 5.31% in 2015 to 4.79% in 2016 resulting in a decrease in interest income due to rate of $203,000.
- The average balance of loans to state and political subdivisions increased $15.7 million from 2015 to 2016 which had a positive impact of $648,000 on total interest income due to volume. The average tax equivalent yield on loans to state and political subdivisions decreased from 4.45% in 2015 to 4.22% in 2016, decreasing interest income by $185,000.

Total interest expense increased $221,000 in 2016 compared to 2015. The increase is attributable to a change in volume as the average balance of interest bearing liabilities increased $174.7 million in 2016, which had the effect of increasing interest expense by $805,000. This increase was attributable to the FNB acquisition, which increased our deposit levels and the increase in borrowings to fund our loan portfolio growth. Increases in average deposits included NOW accounts of $71.0 million, savings accounts of $53.2 million, money markets accounts of $20.0 and certificates of deposit of $20.2 million. The combined impact to interest expense of these increases was an increase $649,000. The average balance of other borrowed funds increased $10.3 million as a result of funding loan growth in the second half of 2016, which corresponds to an increase in interest expense of $156,000.

The average interest rate paid on interest bearing liabilities decreased from 0.66% in 2015 to 0.55% in 2016, which resulted in a decrease in interest expense of $584,000 during 2016. The low interest rate environment had the effect of decreasing our rates on certificate of deposit products. The average rate on certificates of deposit decreased from 1.07% to 0.97% resulting in a decrease in interest expense of $385,000. The average rate paid on other borrowed funds decreased from 1.93% to 1.69% resulting in a decrease in interest expense of $69,000. Decreases in rates paid on NOW accounts, savings accounts and money market accounts were less than 5 basis points, and resulted in a cumulative decrease in interest expense of $130,000.

Our net interest margin for 2016 was 3.68% compared to 3.76% for 2015.

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2017, we recorded a provision for loan losses of $2,540,000. The provision for 2017 was $1,020,000, or 67.1%, higher than the provision in 2016. The increase in the provision for loan losses was primarily the result of the organic loan growth experienced in 2017. (see also "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

For the year ended December 31, 2016, we recorded a provision for loan losses of $1,520,000. The provision for 2016 was $1,040,000, or 216.7%, higher than the provision in 2015. The increase in the provision for loan losses was primarily the result of the organic loan growth experienced in 2016 and the increase in classified loans from December 31, 2015 to December 31, 2016. (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):

NON-INTEREST INCOME

	2017	2016	2015
Service charges	$4,456	$4,461	$4,126
Trust	755	693	673
Brokerage and insurance	635	766	720
Investment securities gains, net	1,035	255	429
Gains on loans sold	578	449	404
Earnings on bank owned life insurance	660	688	628
Other	537	587	443
Total	$8,656	$7,899	$7,423

	2017/2016 Change		2016/2015 Change	
	Amount	%	Amount	%
Service charges	$(5)	(0.1)	$335	8.1
Trust	62	8.9	20	3.0
Brokerage and insurance	(131)	(17.1)	46	6.4
Investment securities gains, net	780	305.9	(174)	(40.6)
Gains on loans sold	129	28.7	45	11.1
Earnings on bank owned life insurance	(28)	(4.1)	60	9.6
Other	(50)	(8.5)	144	32.5
Total	$757	9.6	$476	6.4

2017 vs. 2016

Non-interest income increased $757,000 in 2017 from 2016, or 9.6%. We recorded investment securities gains totaling $1,035,000 compared with net gains of $255,000 in 2016. During 2017, we sold 24 agency securities for a net loss of $147,183 to fund loan growth and to restructure the investment portfolio for future rate increases. We also sold one Agency MBS security for a gain of $20,000. Finally, in anticipation of the adoption of accounting standard ASU 2016-01, the Company chose to sell a significant portion of its equity securities portfolio that resulted in a gain of $1,149,000. We also sold several interest bearing time deposits during 2017 for a gain of $13,000. During 2016, we sold two US treasury securities and one agency security for gains totaling $27,000 and $48,000, respectively, as a result of interest rates at the time of the sale. We sold four municipal securities for gains totaling $80,000. We also sold 7 agency securities for a gain of $2,000 and 6 corporate securities for a loss of $35,000 to fund loan growth that occurred in the fourth quarter. Finally, we sold portions of three of the equity security positions as a result of their rise

in price subsequent to the presidential election for a total gain of $133,000.

Gains on loans sold increased $129,000 compared to last year. During 2017, the Bank generated $25.1 million of residential mortgage loan sale proceeds, which was $3.6 million, or 16.8% more than the proceeds received in 2016. We also sold the credit card portfolio for $1.0 million in 2017 generating a gain on the sale of approximately $39,000.

The decrease in brokerage revenues is due to the loss of service of two employees early in 2017, whose positions remained unfilled for a portion of the year. The increase in trust revenues was due to settling several estates in 2017.

2016 vs. 2015

Non-interest income increased $476,000 in 2016 from 2015, or 6.4%. We recorded investment securities gains totaling $255,000 compared with net gains of $429,000 in 2015. During 2016, we sold two US treasury securities and one agency security for gains totaling $27,000 and $48,000, respectively, as a result of interest rates at the time of the sale. We sold four municipal securities for gains totaling $80,000. We also sold 7 agency securities for a gain of $2,000 and 6 corporate securities for a loss of $35,000 to fund loan growth that occurred in the fourth quarter. Finally, we sold portions of three of the equity security positions as a result of their rise in price subsequent to the presidential election for a total gain of $133,000. 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. Subsequent to the acquisition in 2015, 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 close and as a result no gains or losses were recorded on the sale.

Gains on loans sold increased $45,000 in 2016 compared to 2015, which is the result of the additional market areas obtained as part of the FNB acquisition. During 2016, the Bank generated $21.5 million of loan sale proceeds, which was $2.2 million, or 11.5% more than the proceeds received in 2015.

Service charge income increased by $335,000 in 2016 compared to 2015. The Company experienced a $33,000 increase in fees charged to customers for insufficient funds. ATM income increased $32,000 in 2016 compared to 2015 and interchange revenue increased $272,000. The increases were the result of the additional customers obtained as part of the FNB acquisition.

The increase in earnings on bank owned life insurance of $60,000 is primarily due to the additional insurance obtained as part of the FNB acquisition. The increase in other income is attributable to the FNB acquisition and includes increases in safe deposit rents and loan servicing fees.

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):

	2017	2016	2015
Salaries and employee benefits	$17,456	$16,410	$12,504
Occupancy	1,988	1,900	1,424
Furniture and equipment	603	644	506
Professional fees	1,039	1,094	846
FDIC insurance	385	572	464
Pennsylvania shares tax	705	690	713
Amortization of intangibles	297	327	-
Merger and acquisition	165	-	1,103
ORE expenses	655	389	969
Other	6,021	6,645	4,900
Total	$29,314	$28,671	$23,429

	2017/2016 Change		2016/2015 Change	
	Amount	%	Amount	%
Salaries and employee benefits	$1,046	6.4	$3,906	31.2
Occupancy	88	4.6	476	33.4
Furniture and equipment	(41)	(6.4)	138	27.3
Professional fees	(55)	5.7	248	29.3
FDIC insurance	(187)	(32.7)	108	23.3
Pennsylvania shares tax	15	2.2	(23)	(3.2)
Amortization of intangibles	(30)	(9.2)	327	-
Merger and acquisition	165	N/A	(1,103)	(100.0)
ORE expenses	266	68.4	(580)	(59.9)
Other	(624)	(9.4)	1,745	35.6
Total	$643	2.2	$5,242	22.4

2017 vs. 2016

Non-interest expenses for 2017 totaled $29,314,000, which represents an increase of $643,000, compared to 2016 expenses of $28,671,000. The primary cause of the total increase was salaries and benefits. Salary and benefit costs increased $1,046,000. Base salaries and related payroll taxes increased $902,000 as a result of 2017 merit increases and staffing mix changes. Full time equivalent staffing was 253 and 252 employees for 2017 and 2016, respectively. Retirement and profit sharing expenses increased $235,000 compared to 2016, also as a result of a change in the employee mix and increased profitability.

The increase in ORE expenses is the result of a non-accrual loan paying off in the third quarter of 2016, which resulted in the reimbursement of $240,000 in 2016 of previously paid real estate taxes and legal fees. The decrease in FDIC insurances expense is due to a lower assessment charged by the FDIC. The increase in merger and acquisition expenses is due to the acquisition of the State College branch in 2017. The largest driver of the decrease in other expenses is a decrease of $377,000 in charge-offs related to fraudulent charges on our customers debit cards.

2016 vs. 2015

Non-interest expenses for 2016 totaled $28,671,000, which represents an increase of $5,242,000, compared to 2015 expenses of $23,429,000. The primary cause of the total increase was the acquisition of FNB and the retained employees and branches and the hiring of the lending teams in 2016. Salary and benefit costs increased $3,906,000. Base salaries and related payroll taxes increased $2,848,000. Full time equivalent staffing was 252 and 195 employees for 2016 and 2015, respectively. Health insurance related expenses increased $615,000 from 2015 due to increased claims experience in 2016 from the additional headcount due to the acquisition and hiring of lending teams. Retirement and profit sharing expenses increased $286,000 compared to 2015, also as a result of the increased headcount.

The increases in occupancy and furniture and equipment in 2016 was primarily related to the acquisition and the acquired branches as well as the opening of the office in Mount Joy, Pennsylvania and the limited branch office in Winfield, Pennsylvania. The increase in professional fees was associated with legal fees, as the Company look exited certain contracts and closed a branch in 2016, and consulting fees associated with system upgrades, including the issuance of new debit cards in the third quarter of 2016.

The decrease in merger and acquisition expense is due to the acquisition that occurred in 2015 with no corresponding activity in 2016. The decrease in ORE expenses is the result of a non-accrual loan paying off in the third quarter of 2016, which resulted in the reimbursement of $240,000 of previously paid real estate taxes and legal fees. Additionally, in 2015, there were two OREO write-downs that totaled $262,000 compared to write-downs in 2016 that totaled $60,000.
The largest driver of the increase in other expenses for 2016 was a general expense increase as part of the FNB acquisition. These included additional advertising, phone and data communication, supplies and printing expenses. A second factor was an increase of $200,000 in contributions associated with the Pennsylvania educational improvement tax credit program. Also, we experienced an increase of $240,000 in charge-offs related to fraudulent charges on our customers debit cards.
Provision for Income Taxes
The provision for income taxes was $6,031,000, $3,034,000 and $2,721,000 for 2017, 2016 and 2015, respectively. The effective tax rates for 2017, 2016 and 2015 were 31.7%, 19.4% and 19.0%, respectively.
The increase in income tax expense of $2,997,000 in 2017 has two primary drivers. The first was the increase of $3,384,000 in income before the provision for income taxes, which accounts for an increase in tax expense of $1,151,000 at a 34% tax rate. The second driver was a $1,531,000 increase in tax expense due to the Tax Cuts and Jobs Act, enacted on December 22, 2017, which lowered the federal corporate income tax rate from 35% to 21% effective January 1, 2018. As a result of the lowered tax rate, the carrying value of the Company's net deferred tax asset was reduced by $1,531,000, which was charged to income tax expense. The remaining increase was due to a lower amount of tax exempt income in 2017 and a reduction in tax credits due to one expiring in December of 2016.
Income before the provision for income taxes increased by $1,325,000 in 2016 compared to 2015. As the result of this increase, the provision for income taxes increased by $313,000 when compared to 2015.
We are involved in four limited partnership agreements that established low-income housing projects in our market area. During 2017, we recognized tax credits related to one of the four partnerships and in 2016 and 2015, we recognized tax credits related to two of the four partnerships. Tax credits associated with one project became fully utilized in December 2016. The tax credits for the other two projects were fully utilized by December 31, 2012. We anticipate recognizing an aggregate of $705,000 of tax credits over the next five years.
FINANCIAL CONDITION
The following table presents ending balances (dollars in millions), the dollar amount of change and the percentage change during the past two years:

	2017 Balance	Increase	% Change	2016 Balance	Increase	% Change	2015 Balance
Total assets	$1,361.9	$ 138.9	11.4	$1,223.0	$ 60.0	5.2	$1,163.0
Total investments	254.8	(59.2)	(18.9)	314.0	(45.7)	(12.7)	359.7
Total loans, net	989.3	198.6	25.1	790.7	102.8	14.9	687.9
Total deposits	1,104.9	99.4	9.9	1,005.5	17.5	1.8	988.0
Total borrowings	114.7	35.0	43.9	79.7	38.1	91.6	41.6
Total stockholders' equity	129.0	5.7	4.6	123.3	3.5	2.9	119.8

Cash and Cash Equivalents

Cash and cash equivalents totaled $18.5 million at December 31, 2017 compared to $17.8 million at December 31, 2016. 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):

	2017 Amount	% of Total	2016 Amount	% of Total	2015 Amount	% of Total	2014 Amount	% of Total	2013 Amount	% of Total
Available-for-sale:										
U. S. agency securities	$98,887	38.8	$170,414	54.3	$199,591	55.5	$150,885	49.3	$152,189	48.0
U.S. treasuries	28,604	11.2	3,000	0.9	10,082	2.8	4,849	1.6	11,309	3.6
Obligations of state & political subdivisions	79,090	31.0	96,926	30.9	102,863	28.6	105,036	34.3	95,005	29.9
Corporate obligations	3,083	1.2	3,050	1.0	14,565	4.0	13,958	4.6	16,802	5.3
Mortgage-backed securities	45,027	17.7	37,728	12.0	30,204	8.4	29,728	9.6	40,671	12.8
Equity securities	91	0.1	2,899	0.9	2,432	0.7	1,690	0.6	1,325	0.4
Total	$254,782	100.0	$314,017	100.0	$359,737	100.0	$306,146	100.0	$317,301	100.0

2017

The Company's investment portfolio decreased by $59.2 million, or 18.9%, during the past year primarily due to investment cash flows being utilized to fund loan growth in 2017. During 2017, we purchased $28.8 million of U.S. Treasury securities, $6.1 million of U.S. agencies, $15.7 million of mortgage backed securities, $3.4 million of state and local obligations and $100,000 of equity securities in financial corporations, which helped to offset the $7.5 million of principal repayments and $52.6 million of calls and maturities that occurred during the year. We also sold $50.4 million of bonds and equities at a net gain of $1,022,000. The market value of our investment portfolio decreased approximately $2.3 million in 2017 due to interest rate fluctuations and sales of securities during 2017. Excluding our short term investments consisting of monies held primarily at the Federal Reserve, the effective yield on our investment portfolio for 2017 was 2.52% compared to 2.39% for 2016 on a tax equivalent basis.

During 2017, rates on the short end of the Treasury yield curve increased as a result of the increase in the federal funds rate and the potential for additional future increases in the federal funds rate. This resulted in a flattening of the yield curve. The investment strategy in 2017 was to utilize cashflows from the investment portfolio to fund the strong loan growth the Company has experienced, while maintaining a portfolio sufficient to support our various pledging requirements for deposits, borrowings and liquidity. Investment purchases have been focused on securities with short fixed maturities for treasury and agency securities and short repricing windows for asset backed securities. We have also focused our purchases on securities with lower risk weightings due to the loan growth experienced that carries a higher risk weight for capital adequacy purposes. We continually monitor interest rate trading ranges and try to focus purchases to times when rates are in the top third of the trading range. The Bank believes its investment strategy has appropriately mitigated its interest rate risk exposure if rates continue to rise while providing sufficient cashflows to fund loan growth expected as a result of the loan growth initiatives.

At December 31, 2017, 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.

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The expected principal repayments at amortized cost and average weighted yields for the investment portfolio (excluding equity securities) as of December 31, 2017, 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, which was the rate in effect at December 31, 2017.

	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	$33,502	1.2	$65,952	1.7	$-	-	$-	-	$99,454	1.5
U.S. treasuries	-	-	28,782	2.0	-	-	-	-	28,782	2.0
Obligations of state & political subdivisions	16,194	3.2	50,126	2.6	9,167	3.0	2,922	4.2	78,409	2.8
Corporate obligations	-	-	-	-	3,000	5.8	-	-	3,000	5.8
Mortgage-backed securities	16,643	1.7	18,289	1.9	10,089	2.2	364	2.7	45,385	1.9
Total available-for-sale	$66,339	1.8	$163,149	1.7	$22,256	3.0	$3,286	4.0	$255,030	2.1

At December 31, 2017, approximately 90.0% 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.

2016

The Company's investment portfolio decreased by $45.7 million, or 12.7%, during 2016 primarily due to investment cash flows being utilized to fund loan growth in 2016. During 2016, we purchased $28.6 million of U.S. agencies, $14.2 million of mortgage backed securities, $9.8 million of state and local obligations and $3.0 million of corporate obligations, which helped to offset the $6.1 million of principal repayments and $61.7 million of calls and maturities that occurred during the year. We also sold $30.1 million of bonds and equities at a net gain of $255,000. The market value of our investment portfolio decreased approximately $1.3 million in 2016 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 2016 was 2.39% compared to 2.69% for 2015 on a tax equivalent basis.

During 2016, rates on the short and long end of the Treasury yield curve increased, as the result of the increase in the federal funds rate and the potential for additional future increases in the federal funds rate, as well as the uncertainty surrounding the economic environment as a result of the 2016 presidential election. The investment strategy in 2016 was to purchase agency securities with maturities of less than five years, mortgage backed securities with predictable cash flows and high quality municipal bonds with high coupons.

At December 31, 2016, 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 and the opening of offices in Lancaster County, this focus has grown to include Lebanon, Schuylkill, Berks and Lancaster County markets of south central, Pennsylvania. In 2016, we opened a limited branch office in Union County that is staffed by a lending team to primarily support agricultural opportunities in central Pennsylvania. We also opened a full service branch in Mount Joy, Pennsylvania in 2016. In December 2017, we completed a branch acquisition in State College, which provides us with opportunities in Centre County,

Pennsylvania. We originate loans primarily through direct loans to our existing customer base, with new customers generated through the strong relationships that our lending teams have with their customers, as well as 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, 2017, approximately 77.5% 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 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 participates in 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 2017, we originated $7.5 million in USDA and SBA guaranteed commercial real estate loans.

Agriculture is an important industry throughout our market areas. Therefore, the Bank has not only developed an agriculture lending team with significant experience that has a thorough understanding of this industry, but also hired two additional agricultural lending teams in 2016. We've also developed an agricultural policy to assist in underwriting agricultural loans. Agricultural loans are made to a diversified customer base that include dairy, swine and poultry farmers and their support businesses. 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, 2017, the aggregate balance of our participation loans, in which a portion was sold to other lender's totaled $50.4 million.

Activity associated with exploration for natural gas remained limited in 2017 due to the low price of natural gas produced in our area. There was an increase in pipeline installations in 2017, which may lead to increased exploration in the future. 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):

	2017		2016		2015		2014		2013	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate:										
Residential	$214,479	21.4	$207,423	25.9	$203,407	29.3	$185,438	33.5	$187,101	34.6
Commercial	308,084	30.8	252,577	31.6	237,542	34.2	190,945	34.5	193,087	35.7
Agricultural	239,957	24.0	123,624	15.5	57,822	8.3	24,639	4.4	22,001	4.1
Construction	13,502	1.3	25,441	3.2	15,011	2.2	6,353	1.1	8,937	1.7
Consumer	9,944	1.0	11,005	1.4	11,543	1.7	8,497	1.5	9,563	1.7
Other commercial loans	72,013	7.2	58,639	7.3	57,549	8.2	47,451	8.6	44,488	8.2
Other agricultural loans	37,809	3.8	23,388	2.9	13,657	2.0	11,065	2.0	9,541	1.8
State & political subdivision loans	104,737	10.5	97,514	12.2	98,500	14.1	79,717	14.4	65,894	12.2
Total loans	1,000,525	100.0	799,611	100.0	695,031	100.0	554,105	100.0	540,612	100.0
Less allowance for loan losses	11,190		8,886		7,106		6,815		7,098	
Net loans	$989,335		$790,725		$687,925		$547,290		$533,514	

	2017/2016 Change		2016/2015 Change	
	Amount	%	Amount	%
Real estate:				
Residential	$7,056	3.4	$4,016	2.0
Commercial	55,507	22.0	15,035	6.3
Agricultural	116,333	94.1	65,802	113.8
Construction	(11,939)	(46.9)	10,430	69.5
Consumer	(1,061)	(9.6)	(538)	(4.7)
Other commercial loans	13,374	22.8	1,090	1.9
Other agricultural loans	14,421	61.7	9,731	71.3
State & political subdivision loans	7,223	7.4	(986)	(1.0)
Total loans	$200,914	25.1	$104,580	15.0

2017

Total loans grew $200.9 million in 2017 from $799.6 million at the end of 2016 to $1.0 billion at the end of 2017. In December 2017, the Company completed the acquisition of a branch in State College, Pennsylvania, which included loans totaling $39.8 million. During 2017, excluding the branch acquisition, the Company experienced growth in agricultural real estate loans of $116.3 million, commercial real estate loans of $35.7 million, other agricultural loans of $14.4 million, other commercial loans of $7.5 million and state and political subdivision loans of $4.5 million. A portion of the increases in agricultural real estate and commercial real estate was due to transfers from construction, which decreased $12.3 million, excluding the impact of the State College branch acquisition. The growth in agricultural and commercial loan categories was primarily in our southcentral and central Pennsylvania markets and is a result of entering the south central and central Pennsylvania markets as a result of the FNB acquisition and the hiring of additional agricultural and commercial lenders.

Excluding the State College branch acquisition, residential real estate loans decreased $3.7 million. Demand for non-conforming loans remains limited and was highly competitive, especially in the north central Pennsylvania

market. During 2017, $24.3 million of residential real estate loans were originated for sale on the secondary market, which compares to $22.2 million for 2016. For loans sold on the secondary market, the Company recognizes fee income for servicing these sold loans, which is included in non-interest income.

2016

Total loans grew $104.6 million in 2016 from $695.0 million at the end of 2015 to $799.6 million at the end of 2016. During 2016, the Company experienced growth in agricultural real estate loans of $65.8 million, commercial real estate loans of $15.0 million, construction loans of $10.4 million, other agricultural loans of $9.7 million and other commercial loans of $1.1 million The increases in these areas is the result of entering into the south central Pennsylvania market via the FNB acquisition, the hiring of additional agricultural and commercial lenders in the south central market and the hiring of an agricultural lending team to enter the central Pennsylvania market.

The increase of $4.0 million in residential loans was due us entering the south central Pennsylvania market and making additional residential loans in this market. During 2016, $22.2 million of loans were originated for sale on the secondary market, which compares to $18.9 million for 2015.

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, 2017, 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	$ 23,115	$ 1,062	$24,177
Over one year through five years	79,769	124	79,893
Over five years	659,716	12,316	672,032
Total	$ 762,600	$ 13,502	$776,102
Sensitivity of loans to changes in interest rates - loans due after December 31, 2018:			
Predetermined interest rate	$ 107,942	$ 861	$108,803
Floating or adjustable interest rate	631,543	11,579	643,122
Total	$ 739,485	$ 12,440	$751,925

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, 2017, 2016, 2015, 2014 and 2013. All non-accruing troubled debt restructurings (TDRs) are also included the non-accruing loans totals.

	December 31, 2017	2016	2015	2014	2013
Balance at beginning of period	$8,886	$7,106	$6,815	$7,098	$6,784
Charge-offs:					
Real estate:					
Residential	107	85	66	97	17
Commercial	41	100	84	516	62
Agricultural	30	-	-	-	-
Consumer	130	100	47	47	54
Other commercial loans	-	55	41	250	1
Other agricultural loans	5	-	-	-	-
Total loans charged-off	313	340	238	910	134
Recoveries:					
Real estate:					
Residential	-	-	-	-	5
Commercial	11	479	14	15	5
Agricultural	-	-	-	-	-
Consumer	49	88	33	27	33
Other commercial loans	16	33	2	-	-
Other agricultural loans	1	-	-	-	-
Total loans recovered	77	600	49	42	43
Net loans charged-off (recovered)	236	(260)	189	868	91
Provision charged to expense	2,540	1,520	480	585	405
Balance at end of year	$11,190	$8,886	$7,106	$6,815	$7,098
Loans outstanding at end of period	$1,000,525	$799,611	$695,031	$554,105	$540,612
Average loans outstanding, net	$883,355	$725,881	$577,992	$540,541	$516,748
Non-performing assets:					
Non-accruing loans	$10,171	$11,454	$6,531	$6,599	$8,097
Accrual loans - 90 days or more past due	555	405	623	836	697
Total non-performing loans	$10,726	$11,859	$7,154	$7,435	$8,794
Foreclosed assets held for sale	1,119	1,036	1,354	1,792	1,360
Total non-performing assets	$11,845	$12,895	$8,508	$9,227	$10,154
Troubled debt restructurings (TDR)					
Non-accruing TDRs	$6,798	$6,758	$3,397	$3,654	$4,701
Accrual TDRs	13,056	6,095	2,243	2,502	2,510
Total troubled debt restructurings	$19,854	$12,853	$5,640	$6,156	$7,211
Net charge-offs (recoveries) to average loans	0.03 %	(0.04 %)	0.03 %	0.16 %	0.02 %
Allowance to total loans	1.12 %	1.11 %	1.02 %	1.23 %	1.31 %
Allowance to total non-performing loans	104.33 %	74.93 %	99.33 %	91.66 %	80.71 %
Non-performing loans as a percent of loans net of unearned income	1.07 %	1.48 %	1.03 %	1.34 %	1.63 %
Non-performing assets as a percent of loans net of unearned income	1.18 %	1.61 %	1.22 %	1.67 %	1.88 %

The Company believes it utilizes a disciplined and thorough loan review process based upon its 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 50% (55% for loans between 2016 and 2013 and 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, 2017. 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, other commercial loans and other agricultural 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 $11,190,000 or 1.12% of total loans as of December 31, 2017 as compared to $8,886,000 or 1.11% of loans as of December 31, 2016. The $2,304,000 increase is a result of a $2,540,000 provision for loan losses less net charge-offs of $236,000. The decrease as a percent of loans for 2017, 2016 and 2015 when compared to 2014 and 2013 is attributable to the increase in loans as part of the acquisition of FNB and the State College branch acquisition and the associated purchase accounting adjustments that were applied to the acquired loan portfolios. 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:

	2017		2016		2015		2014		2013	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Residential	$1,049	21.4	$1,064	25.9	$905	29.3	$878	33.5	$946	34.6
Commercial	3,867	30.8	3,589	31.6	3,376	34.2	3,419	34.5	3,983	35.7
Agricultural	3,143	24.0	1,494	15.5	409	8.3	451	4.4	575	4.1
Construction	23	1.3	47	3.2	24	2.2	26	1.1	50	1.7
Consumer	124	1.0	122	1.4	102	1.7	84	1.5	105	1.7
Other commercial loans	1,272	7.2	1,327	7.3	1,183	8.2	1,007	8.6	686	8.2
Other agricultural loans	492	3.8	312	2.9	122	2.0	217	2.0	256	1.8
State & political subdivision loans	816	10.5	833	12.2	593	14.1	545	14.4	330	12.2
Unallocated	404	N/A	98	N/A	392	N/A	188	N/A	167	N/A
Total allowance for loan losses	$11,190	100.0	$8,886	100.0	$7,106	100.0	$6,815	100.0	$7,098	100.0

As a result of previous loss experiences and other 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 54.8% of the loan portfolio, 62.7% of the allowance is assigned to these portions 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 21.4% of the loan portfolio as of December 31, 2017 and 9.37% 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, 2016 to December 31, 2017 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, 2017				December 31, 2016			
	30 - 89 Days Past Due Accruing	Non-Performing Loans			30 - 89 Days Past Due Accruing	Non-Performing Loans		
		90 Days Past Due Accruing	Non-accrual	Total Non-Performing		90 Days Past Due Accruing	Non-accrual	Total Non-Performing
Real estate:								
Residential	$1,550	$218	$1,386	$ 1,604	$1,010	$333	$1,570	$ 1,903

Commercial	1,519	162	5,192	5,354	1,703	-	4,445	4,445
Agricultural	242	30	175	205	-	-	1,340	1,340
Construction	-	-	133	133	-	-	-	-
Consumer	86	7	42	49	131	67	42	109
Other commercial loans	50	32	2,637	2,669	78	-	4,057	4,057
Other agricultural loans	42	106	606	712	77	5	-	5
Total nonperforming loans	$3,489	$555	$10,171	$ 10,726	$2,999	$405	$11,454	$ 11,859

	Change in Non-Performing Loans 2017 / 2016	
	Amount	%
Real estate:		
Residential	$(299)	(15.7)
Commercial	909	20.4
Agricultural	(1,135)	(84.7)
Construction	133	-
Consumer	(60)	(55.0)
Other commercial loans	(1,388)	(34.2)
Other agricultural loans	707	14,140.0
Total nonperforming loans	$(1,133)	(9.6)

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				
	2017	2016	2015	2014	2013
Real estate:					
Residential	$1,604	$1,903	$1,402	$1,174	$1,037
Commercial	5,354	4,445	4,482	5,320	7,591
Agricultural	205	1,340	34	-	-
Construction	133	-	-	-	-
Consumer	49	109	64	53	16
Other commercial loans	2,669	4,057	1,172	888	150
Other agricultural loans	712	5	-	-	-
State & political subdivision loans	-	-	-	-	-
Total nonperforming loans	10,726	11,859	7,154	7,435	8,794

For the year ended December 31, 2017, we recorded a provision for loan losses of $2,540,000 which compares to $1,520,000 for the same period in 2016, an increase of $1,020,000. The increase is primarily attributable to the organic loan growth for 2017. Non-performing loans decreased $1,133,000 from December 31, 2016 to December 31, 2017 with the decrease being primarily related to one agricultural relationship that paid off in 2017. At December 31, 2017, approximately 63.3% of the Bank's non-performing loans are associated with the following three customer relationships:

- A commercial loan relationship of $3.2 million, secured by undeveloped land, stone quarries and equipment, was on non-accrual status as of December 31, 2017. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer, who provides excavation services and stone for pad construction related to these activities. During 2017, the Company had the underlying collateral appraised. The appraisals indicated a decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. Management determined that no specific reserve was required as of December 31, 2017.
- A commercial loan relationship of $2.7 million, secured by residential rental properties, was on non-accrual status as of December 31, 2017. 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. During 2016, the Company appraised the underlying collateral. The appraisals indicated a slight decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. 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, 2017, there was no specific reserve for this relationship.

- A commercial loan relationship of $902,000, secured by residential rental properties, was on non-accrual status as of December 31, 2017. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer, as he rented his properties to individuals working on the exploration activities. During 2017, the Company had the underlying collateral appraised. The appraisals indicated a decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. Management determined that no specific reserve was required as of December 31, 2017.

Management believes that the allowance for loan losses at December 31, 2017 was adequate at that date, which was based on the following factors:

- Three loan relationships comprise 63.3% of the non-performing loan balance, whose debt is considered well collateralized as of December 31, 2017.
- As seen on page 39, the Company has a history of low charge-offs, which continued in 2017 as the net charge-offs were .03% of average loans and only $236,000. In 2016, a net recovery was experienced as the result of recovering a loan that was partially charged off in 2014.

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, 2017 and 2016, the cash surrender value of the life insurance was $26.9 million and $26.2 million, respectively. 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 $660,000, $688,000 and $628,000 in 2017, 2016 and 2015, 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. As of December 31, 2017 and 2016, included in other liabilities on the Consolidated Balance sheet is a liability of $578,000 and $569,000, respectively, for the obligation under the split-dollar benefit agreements.

Other Assets

2017

Other assets increased $1.2 million in 2017 to $14.7 million from $13.5 million in 2016. As a result of an increase in FHLB borrowings regulatory stock increased $1.5 million. The deferred tax asset decreased $1.3 million, primarily due to a change in the federal income tax rate to 21%. As a result of funding the pension plans, pension plan assets increased from $0 to $717,000.

2016

Other assets increased $1.4 million in 2016 to $13.5 million from $12.1 million in 2015. Due to the increase in FHLB borrowings, regulatory stock increased $1.8 million.

Deposits

The following table shows the breakdown of deposits by deposit type (dollars in thousands) at December 31:

	2017		2016		2015	
	Amount	%	Amount	%	Amount	%
Non-interest-bearing deposits	$171,840	15.6	$147,425	14.7	$150,960	15.3
NOW accounts	337,307	30.5	305,862	30.4	279,655	28.3
Savings deposits	184,057	16.7	170,722	17.0	170,277	17.2
Money market deposit accounts	145,287	13.1	116,880	11.6	105,229	10.7
Certificates of deposit	266,452	24.1	264,614	26.3	281,910	28.5
Total	$1,104,943	100.0	$1,005,503	100.0	$988,031	100.0

	2017/2016 Change		2016/2015 Change	
	Amount	%	Amount	%
Non-interest-bearing deposits	$24,415	16.6	$(3,535)	(2.3)
NOW accounts	31,445	10.3	26,207	9.4
Savings deposits	13,335	7.8	445	0.3
Money market deposit accounts	28,407	24.3	11,651	11.1
Certificates of deposit	1,838	0.7	(17,296)	(6.1)
Total	$99,440	9.9	$17,472	1.8

2017

Total deposits increased $99.4 million in 2017, or 9.9%. The State College branch acquisition accounted for $37.9 million of this growth, with the remaining $61.5 million being organic growth. Excluding the acquisition, growth was experienced across all product lines and customer types, with the exception of certificates of deposit (CD). Excluding the acquisition, non-interest bearing accounts increased $18.9 million in 2017. As a percentage of total deposits, non-interest bearing deposits totaled 15.6% as of the end of 2017, which compares to 14.7% at the end of 2016. 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.

NOW accounts increased by $31.4 million and money market deposit accounts increased by $10.1 million, exclusive of the acquisition, since the end of 2016. The primary causes of the increase in NOW accounts and money market accounts was in state political organizations as we continue to gather deposits from our local municipalities and school districts. Due to the low interest rate environment, individuals moved money from certificates of deposit to savings accounts. Excluding the acquisition, savings accounts increased $12.6 million, CDs decreased $11.4 million. During 2017, the Company continued to pay historically low rates on certificates of deposits due to the interest rate environment. Certain customers who typically utilize certificate of deposits as a means of generating income or as a longer term investment option, were continuing to move 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. With the increase in the fed funds rate during 2017, the Bank increased interest rates on both certificates of deposits and certain transactional deposit accounts.

2016

Total deposits increased $17.5 million in 2016, or 1.8%. The primary driver of the increase was an increase in public deposits. This was due to the fact that at December 31, 2015, 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. Once a budget was passed in 2016, funding was restored to the local public governments.

Non-interest bearing deposits decreased $3.5 million in 2016. As a percentage of total deposits, non-interest bearing deposits totaled 14.7% as of the end of 2016, which compares to 15.3% at the end of 2015.
NOW accounts increased by $26.2 million and money market deposit accounts increased by $11.7 million since the end of 2015. The primary causes of the increase in NOW accounts and money market accounts was the resolution of the Pennsylvania budget stalemate described previously and transfers from certificates of deposit. Certificates of deposits decreased in 2016 by $17.3 million. During 2016 the Company continued to pay historically low rates on CDs, which resulted in the Company's customers looking for other investment alternatives and liquidity.

Remaining maturities of certificates of deposit of $100,000 or more are as follows (dollars in thousands) at December 31:

	2017	2016	2015
3 months or less	$15,118	$13,402	$17,475
Over 3 months through 6 months	12,461	10,299	11,804
Over 6 months through 12 months	23,775	41,481	27,226
Over 12 months	82,572	59,324	69,875
Total	$133,926	$124,506	$126,380
As a percent of total certificates of deposit	50.26 %	47.05 %	44.83 %

Interest expense on certificates of deposit of $100,000 or more amounted to $1,504,000, $1,415,000 and $1,406,000 for the years ended December 31, 2017, 2016, and 2015, respectively.
Deposits by type of depositor are as follows (dollars in thousands) at December 31:

	2017		2016		2015	
	Amount	%	Amount	%	Amount	%
Individuals	$651,845	59.0	$624,030	62.0	$634,109	64.2
Businesses and other organizations	229,425	20.8	200,718	20.0	193,527	19.6
State & political subdivisions	223,673	20.2	180,755	18.0	160,395	16.2
Total	$1,104,943	100.0	$1,005,503	100.0	$988,031	100.0

Borrowed Funds
2017
Borrowed funds increased $35.0 million during 2017. The increase was associated with an increase of $36.3 million of short term borrowings from the FHLB, which was used to fund the organic loan growth experienced by the Bank in 2017. In addition, we experienced a $682,000 increase in repurchase agreements. Term loans totaled $14.5 million and $16.5 million as of December 31, 2017 and 2016, respectively. The change in term loans was due to a $2.0 million maturity in 2017 (see Note 9 of the consolidated financial statements for additional information). Management continually monitors interest rates in order to minimize interest rate risk in future years and as part of this may extend some of the short term borrowings via term notes. Short term borrowings from the FHLB were $77.7 million as of December 21, 2017 compared to $41.3 million as of December 31, 2016.
2016
Borrowed funds increased $38.0 million during 2016. The increase was associated with an increase of $39.7 million of short term borrowings from the FHLB, which was used to fund the organic loan growth experienced by the Bank in 2016. The increase was offset by a decrease of $1.7 in repurchase agreements. Term loans totaled $16.5 million as of December 31, 2016 and 2015 (see Note 9 of the consolidated financial statements for additional information). Short term borrowings from the FHLB were $41.3 million as of December 21, 2016 compared to $1.6 million as of December 31, 2015.

Other Liabilities

2017

Other liabilities decreased $1.5 million during 2017, or 10.8%. The primary driver of the decrease was a decrease in pension liabilities due to contributions made to the plan in 2017.

2016

Other liabilities increased $1.0 million during 2016, or 8.08%. The primary driver of this increase was a contract enhancement payment, which will be recognized over the life of the contract of five years, which had a balance at December 31, 2016 of $1.3 million.

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 cash dividend rate after considering our capital requirements, current and projected net income, and other factors. In 2017 and 2016, the Company paid out 44.97% and 44.12% of net income in cash dividends, respectively.

As of December 31, 2017, the total number of common shares outstanding was 3,486,874. For comparative purposes, outstanding shares for prior periods were adjusted for the June 2017 stock dividend in computing earnings and cash dividends per share as detailed in Note 1 of the consolidated financial statements. During 2017, we purchased 17,990 shares of treasury stock at a weighted average cost of $54.40 per share. The Company awarded 4,482 shares of restricted stock to employees at a weighted average cost per share of $53.84 under an equity incentive plan. The Board of Directors was awarded 1,350 shares at a cost of $53.47 per share under equity incentive program.

There are currently four federal regulatory measures of capital adequacy. The Company's ratios meet the regulatory standards for well capitalized for 2017 and 2016, as detailed in Note 14 of the consolidated financial statements.

2017

Stockholders' equity increased 4.7% in 2017 to $129.0 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 $7.7 million, or 6.2%. This increase is due to net income of $13,025,000, offset by net cash dividends of $5,177,000 and net treasury stock activity of $21,000. All of the Company's debt 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 decreased $2,006,000 from December 31, 2016 as result of the decrease in the fair market value of the investment portfolio and the cumulative effect adjustment for the adoption of ASU 2018-02 - Income Statement-Reporting Comprehensive Income (Topic 220). Total stockholders' equity was approximately 9.47% of total assets as of December 31, 2017, compared to 10.08% of total assets as of December 31, 2016.

2016

Stockholders' equity increased 2.9% in 2016 to $123.3 million. Excluding accumulated other comprehensive income, stockholders' equity increased $4.7 million, or 3.9%. This increase is due to net income of $12,638,000, offset by net cash dividends of $5,081,000 and net treasury stock activity of $2,391,000. Accumulated other comprehensive income decreased $1,156,000 from December 31, 2015 primarily as result of the decrease in the fair market value of the investment portfolio. Total stockholders' equity was approximately 10.08% of total assets as of December 31, 2016, compared to 10.30% of total assets as of December 31, 2015.

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 2017 totaled $208,000, which included:

§ Mail equipment totaling $73,000
§ Compliance and other software totaling $25,000
§ Computer and copier upgrades totaling $49,000

Capital expenditures in 2016 totaled $587,000, which included:

§ ATM upgrades totaling $329,000
§ Leasehold improvements to open the Mount Joy branch and the Winfield limited branch office totaling $137,000
§ Computer and copier upgrades totaling $98,000
§ Bank vehicle replacement of $17,000

These expenditures will support our initiatives and will create operating efficiencies, while providing quality customer service.

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 $453.4 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, 2017, which is unsecured and a borrower in custody agreement was established with the FRB in the amount of $4.4 million, which is collateralized by $14.6 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, 2017, the Company (unconsolidated basis) had liquid assets of $6.2 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, 2017, 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	$838,491	$ -	$ -	$ -	$838,491
Time deposits					