# ORANGE COUNTY BANCORP, INC.

## 2016 ANNUAL REPORT

# BOARD OF DIRECTORS

BACK ROW: RICHARD ROWLEY, TERRY SATURNO, PAUL T. MCDERMOTT, MICHAEL GILFEATHER, SUSAN METZGER, WILLIAM D. MORRISON

FRONT ROW: VIRGINIA RIZZO, LOUIS HEIMBACH (CHAIRMAN), DAVID A. DEWILDE

orange county BANCORP, inc.

## MEMBER

Federal Reserve System
Federal Home Loan Bank
Federal Deposit Insurance Corporation
Financial Industry Regulatory Authority

## SUBSIDIARIES

Orange Bank & Trust Company ("Bank")
Hudson Valley Investment Advisors, Inc. ("HVIA")

## SHARES OF ORANGE COUNTY BANCORP, INC. STOCK ARE AVAILABLE UNDER STOCK SYMBOL OCBI

**For information regarding stock transfers and other transactions, contact our Transfer Agent:**

Computershare, Inc.
P.O. BOX 30170
College Station, TX 77842
1.800.368.5948
Web.queries@computershare.com

**For more information about purchasing stock, contact either:**

STIFEL NICOLAUS & CO. INC.
Andrew Lieb: 800.342.2325 Ext. 4128

RAYMOND JAMES EQUITY CAPITAL MARKETS
Douglas W. Deubel: 888.734.0540

HOVDE GROUP
James D. Nuber: 312.361.1810

## NOTICE TO SHAREHOLDERS ANNUAL DISCLOSURE STATEMENT

Financial information about the Bank is available to our customers and the general public upon request. In accordance with the federal regulation to facilitate more informed decision-making by depositors, investors, and the general public, we will provide an ANNUAL DISCLOSURE STATEMENT containing financial information for the Bank for the previous two years. This information will be updated annually and available as of June 1, each year.

**To obtain a copy of the ANNUAL DISCLOSURE STATEMENT, please contact:**
**Gerard Perri, SVP/Chief Financial Officer**
**Orange Bank & Trust Company**
**212 Dolson Avenue**
**Middletown, New York 10940**

# LETTER FROM THE CHAIRMAN AND PRESIDENT

Fitzgerald Falls—Orange County, NY

Dear Shareholders:

We are pleased to present you with the 2016 Annual Report of Orange County Bancorp, Inc. (the "Company"). The Company is the parent organization for Orange Bank & Trust Company (the "Bank") and Hudson Valley Investment Advisors, Inc. ("HVIA").

2016 was a highly productive and newsworthy year for the Bank. Our solid financial results reflect the return on recent investments in people, market expansion and product. In addition, the year was highlighted by the Bank's name change in July from Orange County Trust Company to Orange Bank & Trust Company. Not only did we change the name, but we also created a new logo and brand reconstruction that is reflected in all marketing and advertising efforts.

Total Assets rose 10% from $823 million on December 31, 2015 to $910 million on December 31, 2016.

We continue to experience strong loan growth with Net Loans increasing 22% from $437 million on December 31, 2015 to $534 million on December 31, 2016. Moreover, our Net Income was $3.6 million, Return on Average Assets (ROAA) was 0.41%, Return on Average Equity (ROAE) was 3.79%, and Earnings per Share (EPS) were approximately $1.86 for the year.

Our Annual Shareholder Meeting will be held on May 16, 2017.

Orange Bank & Trust Company turns 125 years old in 2017 and, though we continue to adhere to traditional, conservative banking principles, we are forging ahead with significant investments that will position the Bank as a leader in the delivery of modern community banking products and services.

In addition, HVIA has overhauled much of its operation to improve its service model and product set.

Together, the Bank and HVIA provide a broad array of personal and business financial services designed to make life easier for our clients. Later this year, please look for our launch of a Private Banking service offering. There is currently nothing like Orange Private Banking in the local community bank space and we believe this service will further differentiate the Company as a leader in the market.

We want to thank all our clients, shareholders, directors and employees for their support and contributions to our continued growth in 2016.

Sincerely,

Lou Heimbach
Chairman

Michael Gilfeather
President & CEO

# A NEW NAME AND A NEW LOGO REFLECTS OUR Strength and Our Growth

Orange Bank & Trust marked the introduction of the new name at a ceremony on July 29, 2016 at its Middletown headquarters on Dolson Avenue where CEO, Michael Gilfeather and Board Chairman Louis Heimbach unveiled the new name and signage.

At the end of July—for only the second time in our 125-year history—the Bank changed its name. This evolution—from Orange County Trust Company to Orange Bank & Trust Company—supports our strategic plan to remain independent, position the Bank for future growth, and continue to expand operations regionally with a focus on business banking. A new logo and branded marketing campaign accompanied this historic change.

During a 2015 strategic research and branding initiative, focus groups revealed that, in neighboring counties, "Orange County Trust Company" sounded more like an investment house than a full service commercial bank. Our new name eliminates confusion about what Orange Bank & Trust Company provides its clients by clearly referencing the "Bank" component of our service offering. Our new logo also emphasizes "Orange", as a reminder of our foundational roots, and highlights the bright and positive future we envision for the region.

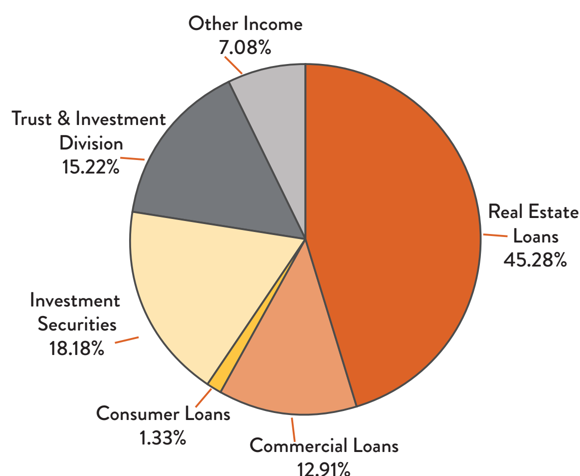
Although the Bank's name and logo changed, we remain the same community-focused bank continuing to deliver top-notch, relationship-based service to our clients in Orange, Dutchess, Westchester and Rockland counties.

# Financial Highlights

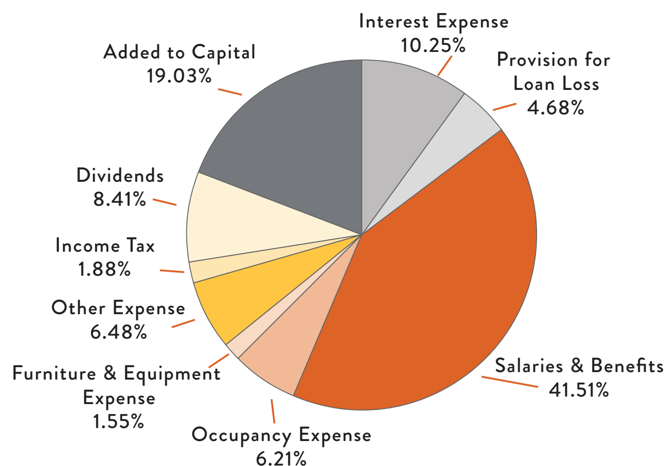
(dollars in thousands except for per share data)

| YEAR | 2016 | 2015 |
|---|---|---|
| Interest income | $ 29,762 | $ 25,235 |
| Interest expense | 3,924 | 4,159 |
| Net interest income after provision for loan losses | 24,046 | 15,191 |
| Other operating income | 8,525 | 8,463 |
| Other operating expenses | 28,213 | 25,565 |
| Net (loss) income | 3,637 | (160) |
| Cash dividends declared | (3,219) | (3,222) |
| Average net loans | 503,454 | 361,982 |
| Average assets | 897,300 | 775,386 |
| Average deposits | 707,512 | 587,874 |
| Average equity | 96,129 | 96,078 |
| **YEAR END** | | |
| Net loans | $ 534,127 | $ 437,218 |
| Assets | 910,688 | 822,829 |
| Deposits | 712,030 | 638,552 |
| Equity | 93,357 | 94,967 |
| **PER SHARE** | | |
| Earnings (loss) | $ 1.86 | $ (0.08) |
| Cash dividends declared | 1.65 | 1.65 |
| Equity | 47.72 | 48.53 |
| **RATIOS** | | |
| Return on average assets | 0.41% | -0.02% |
| Return on average equity | 3.79% | -0.17% |

## OPERATING REVENUE 2016




## DISTRIBUTION OF REVENUE 2016



Our new Rockland location at
254 South Main Street, New City, NY 10956

# More Expansion in Our Newest Markets

WE CONTINUED OUR PROGRESSION WITH THE ADDITION OF HIGHLY QUALIFIED RELATIONSHIP MANAGERS AND CONVENIENT LOCATIONS.

Sharon Spina and Michael Golio, our new team for the Northern Westchester market, opened a full-service branch in Mount Pleasant. Rose Silvestro and Susan Fuller joined us and cut the ribbon on a new full service branch in Mamaroneck. And, Patrick Smith is in the process of establishing another full-service branch in Mt. Vernon.

Our new locations have been well received and we anticipate business will grow as we further cultivate these markets. We are exploring additional locations in Westchester currently, with a view toward better serving the region's potential client base, and anticipate opening a second Rockland branch in 2017.

Expansion and growth continued in the Rockland Division as well in 2016. While operating out of temporary quarters on Maple Avenue in New City, we grew total deposits by more than 11.5% and net loans by more than 22%. We finalized the lease for Rockland's Corporate branch at 254 South Main Street in New City and will move in early May 2017. We also added seasoned business bankers to the team including, Solange Jacques and Sue Russo.

# Business Banking

## STRONG RELATIONSHIPS AND VALUE ADDED SOLUTIONS CONTRIBUTE TO A PROFITABLE YEAR

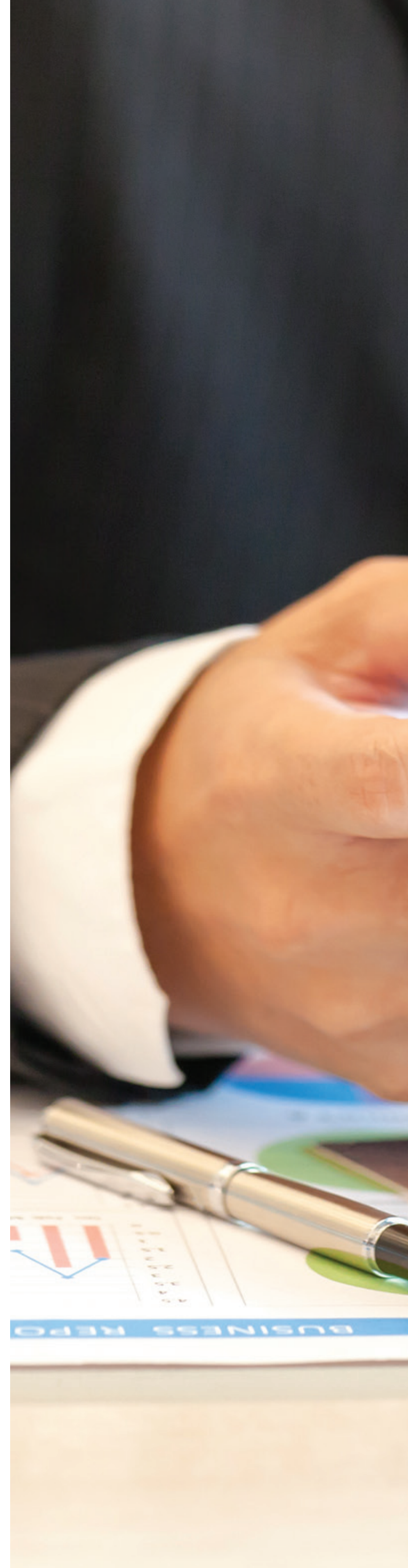
We strive to be known as the region's premier community bank focused on business banking. With our sights squarely on that goal, we continued in 2016 to deliver a full suite of sophisticated banking products that businesses need to thrive.

Small to medium-sized companies play a vital role in our region's economy. To meet their needs and be customer focused and nimble, our Lending department runs a full, in-house loan operations team. Overall, in 2016 the Bank's net loans increased 22% to $534 million. This is a direct reflection of our team's ability to build relationships with our clients. We are deal focused and responsive, offering custom-designed commercial and consumer loans that are expeditiously processed, underwritten and approved in house.

Our **Cash Management** product is a comprehensive set of solutions that help our business clients reduce administrative tasks and save time handling inflow, outflow, and reporting, so they can remain focused on their customers. In 2016 we added five new features to better serve our business clients including:

- Escrow
- Treasury
- Mobile Banking/Mobile Deposit
- Lock Box
- RISK & FRAUD Analytics in conjunction with introducing on-line Wire & ACH

General business banking services, including loans, deposits, and Cash Management, continue to be key components of our growth and expansion. Our relationship banking team also emphasizes our specialty services such as **Esquire Banking** for lawyers, **Med-Banking** for healthcare professionals, and **Municipal Banking** for the public sector. These are designed to make banking more convenient and efficient for professionals, allowing them more time to attend to their clients and ultimately afford them a better quality of life.



Gus Scacco CEO/Chief Investment Officer at Hudson Valley Investment Advisors, Inc. and Melissa Mineau Vice President, Relationship Manager at Hudson Valley Investment Advisors, Inc.

# Trust & Investment Advisory

Trust and Investment Advisory services are delivered through a unique partnership between the Bank's Trust Services Division and **Hudson Valley Investment Advisors, Inc. (HVIA)**. In 2016, the Trust Services Division expanded its team and significantly grew its asset base. Sinead Fitzsimons, VP & Senior Trust Officer, Ana Gomez, Trust Officer, and Hilda Cabrera, Trust Administrator, added tremendous experience in the areas of Special Needs Trusts, Court-Appointed Trusts and Guardianships. Their talents and strong client and referral relationships helped the Division add $53 million in new client assets, to $298 million, a nearly 22% increase for the year. This resulted in a greater than 30% increase in gross revenue, continuing growth that began in 2015.

HVIA also enjoyed continued momentum in 2016. Net Assets Under Management (AUM) increased to $706 million, and net income grew by 11.2%, to $768 thousand.

The firm expanded its product offerings in 2016 with a new mutual fund, HVIA Equity Fund (ticker: HVEIX) and added technology upgrades in trading, research and operations to position the business for future growth.

Additionally, to improve communications with new and existing clients, HVIA introduced a new website and video outreach program, and held its first annual Year Ahead Conference. The Trust Services Division also expanded its investment capabilities during the year via a partnership with ARS Investment Partners, LLC, complimenting the in-house resources of Hudson Valley Investment Advisors, Inc.

The future growth of our Trust & Investment Advisory business in 2017 looks promising, and we look forward to continued expansion of our partnerships with local professionals as we focus on providing tailored solutions for our clients' trust, estate, and investment needs.

# A Community Bank Supporting its Communities

**Orange-Ulster BOCES** serves component districts and community in the development of continuous learners who will be successful in meeting the challenges of living in our society today and in the future. In partnership with OBTC, Orange-Ulster BOCES hosted 34 Career and Technical Education Students and guests at the 2nd Annual Recognition Dinner in June. The students were selected by teachers and staff for their academic achievement and outstanding character. OBTC President and CEO Michael Gilfeather said, "The development of skills and hands-on experience empowers students to apply their learning to real opportunities." Career and Technical Education focuses on career paths for all students and Orange Bank and Trust recognizes that their success and introducing them to the business community provides a foundation for future success.

**The honorees at the Orange-Ulster BOCES 2nd Annual Recognition Dinner.**

**The Town of Wallkill Boys and Girls Club** provides 14 programs for almost 6,000 young people in Orange and Sullivan Counties. More than 60% live at, or below, the poverty level and 50% are in single parent-guardian or foster care families. Many depend on the 50,000 meals and 90,000 healthy snacks provided by the Clubs. OBTC is proud to be a supporter, investing in the future leaders of our region, as a corporate, Silver Sponsor.

Michael Gilfeather, OBTC President and CEO and Debra Weaver, Trust Way Branch Manager, present the Silver Sponsor to Executive Director, Lori Rivenburgh.

**The Jewish Community Center of Rockland (JCC)** is multi-generational, providing social, recreational and cultural programs to more than 10,000 residents. The facility includes an early childhood center, senior adult program and senior center, a fitness and wellness center, cultural and arts, teen philanthropy and leadership, and youth sports programs.

Greg Sousa, 1st Vice President Relationship Manager, OBTC; John Bartolotta, Rockland Regional President, OBTC; David A. Kirschtel, Chief Executive Officer, JCC Rockland; Michael Gilfeather, President & CEO, OBTC; Elena Heydt, Director of Donor Relations, JCC Rockland at the donation presentation.

**SHORE (Sheltering the Homeless Is Our Responsibility)** and **I CARE (Interfaith Council for Affordable Residence)** are housing organizations serving the Central Westchester area. SHORE is an all-volunteer, not for profit that has developed 22 units of new, affordable housing with 15 rental and 7 ownership properties. I CARE now houses 12 low-income families in Larchmont/Mamaroneck. The Bank was proud to support both at their annual fund-raising, benefit dinner.

**The United Way of Dutchess-Orange Region** served almost 125,000 individuals last year, including almost 35,000 volunteer hours with an economic impact of nearly $1 million dollars. As the area's premiere impact organization, United Way fights for the health, education and financial stability of every person in our community. We continue to work with United Way to provide resources for their over 70 community service partners by raising almost $20,000 through OBTC employee and corporate contributions.

Michael Gilfeather accepts the honor as a Community and Civic Leader from Orange County Executive Steve Neuhaus and United Way President and CEO Jeannie Montano, at the 2016 Campaign Kick-Off Breakfast.

Hessian Lake, near
Bear Mountain, NY

# Financials

Tel: 717-233-8800
Fax: 717-233-8801
www.bdo.com

945 E. Park Drive, Suite 103
Harrisburg, PA 17111

## Independent Auditor's Report

Board of Directors and Shareholders
Orange County Bancorp, Inc.
Middletown, New York

We have audited the accompanying consolidated financial statements of Orange County Bancorp, Inc. and its subsidiaries, which comprise the consolidated statements of condition as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### *Management's Responsibility for the Consolidated Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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BDO is the brand name for the BDO network and for each of the BDO Member Firms.

*Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Orange County Bancorp, Inc. and its subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Harrisburg, Pennsylvania
April 27, 2017

# CONSOLIDATED STATEMENTS OF CONDITION

**December 31, 2016 and 2015**

(in thousands except for share and per share data)

| | 2016 | 2015 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | **$ 27,338** | $ 15,591 |
| Investment securities - available-for-sale | **279,283** | 304,829 |
| Restricted investment in bank stocks | **4,774** | 3,817 |
| Loans | **541,866** | 444,371 |
| Allowance for loan losses | **(7,739)** | (7,153) |
| Loans, net | **534,127** | 437,218 |
| Premises and equipment | **14,292** | 14,384 |
| Other real estate owned | **1,585** | - |
| Accrued interest receivable | **2,580** | 2,472 |
| Cash surrender value of bank-owned life insurance | **25,731** | 25,007 |
| Goodwill | **5,359** | 5,359 |
| Intangible Assets | **3,106** | 3,392 |
| Other assets | **12,513** | 10,760 |
| TOTAL ASSETS | **$ 910,688** | $ 822,829 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Deposits: | | |
| Noninterest bearing | **$ 160,886** | $ 108,218 |
| Interest bearing | **551,144** | 530,334 |
| Total deposits | **712,030** | 638,552 |
| Short-term borrowings | **25,000** | - |
| Long-term debt | **63,165** | 73,215 |
| Accrued expenses and other liabilities | **17,136** | 16,095 |
| TOTAL LIABILITIES | **817,331** | **727,862** |
| **STOCKHOLDERS' EQUITY** | | |
| Common stock, $0.50 par value; 5,000,000 and 2,000,000 shares authorized; 1,993,438 and 1,995,938 issued; 1,956,770 and 1,955,610 outstanding at December 31, 2016 and 2015, respectively | **998** | 998 |
| Surplus | **70,472** | 70,534 |
| Undivided profits | **27,565** | 27,147 |
| Accumulated other comprehensive loss, net of taxes | **(4,174)** | (2,033) |
| Treasury stock, at cost; 36,668 and 40,328 shares at December 31, 2016 and 2015, respectively | **(1,504)** | (1,679) |
| TOTAL STOCKHOLDERS' EQUITY | **93,357** | 94,967 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | **$ 910,688** | $ 822,829 |

See accompanying notes to consolidated financial statements.

# CONSOLIDATED STATEMENTS OF INCOME

**Years Ended December 31, 2016 and 2015**

(in thousands except for share and per share data)

| | 2016 | 2015 |
|---|---|---|
| **INTEREST INCOME** | | |
| Interest and fees on loans | **$ 22,791** | $ 17,257 |
| Interest on investment securities: | | |
| Taxable | **4,560** | 5,214 |
| Tax exempt | **2,311** | 2,726 |
| Interest on Federal funds sold and other | **100** | 38 |
| TOTAL INTEREST INCOME | **29,762** | 25,235 |
| **INTEREST EXPENSE** | | |
| Interest on savings and NOW accounts | **486** | 515 |
| Interest on time deposits | **822** | 570 |
| Interest on short-term borrowings | **12** | 3 |
| Interest on long-term debt | **2,604** | 3,071 |
| TOTAL INTEREST EXPENSE | **3,924** | 4,159 |
| NET INTEREST INCOME | **25,838** | 21,076 |
| Provision for loan losses | **1,792** | 5,885 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | **24,046** | 15,191 |
| **OTHER OPERATING INCOME** | | |
| Service charges on deposit accounts | **931** | 1,018 |
| Trust and investment division income | **5,826** | 5,254 |
| Investment securities gains | **309** | 834 |
| Earnings on bank-owned life insurance | **724** | 725 |
| Other | **735** | 632 |
| TOTAL OTHER OPERATING INCOME | **8,525** | 8,463 |
| **OTHER OPERATING EXPENSES** | | |
| Salaries | **12,359** | 11,123 |
| Employee benefits | **3,636** | 3,874 |
| Occupancy expense | **2,377** | 2,199 |
| Furniture and equipment expense | **593** | 508 |
| Professional fees | **1,943** | 1,558 |
| Directors' fees and expenses | **741** | 681 |
| Computer software expense | **1,326** | 1,006 |
| FDIC assessment | **533** | 596 |
| Advertising expenses | **937** | 652 |
| Telephone expenses | **412** | 322 |
| Net expenses from other real estate owned | **-** | 603 |
| Intangible amortization | **286** | 286 |
| Other | **3,070** | 2,157 |
| TOTAL OTHER OPERATING EXPENSES | **28,213** | 25,565 |
| Income (loss) before income taxes | **4,358** | (1,911) |
| Provision (benefit) for income taxes | **721** | (1,751) |
| NET INCOME (LOSS) | **$ 3,637** | $ (160) |
| Basic earnings (loss) per share | **$ 1.86** | $ (0.08) |
| Cash dividends declared per share | **$ 1.65** | $ 1.65 |
| Weighted average shares outstanding | **1,956,306** | 1,957,016 |

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
**Years Ended December 31, 2016 and 2015**

(in thousands)

| | **2016** | 2015 |
|---|---|---|
| **Net Income (Loss)** | **$ 3,637** | $ (160) |
| **Other Comprehensive (Loss) Income, Net of Tax** | | |
| Securities available for sale: | | |
| Gross unrealized holding (losses) arising during the year (net of tax of $(1,117) and $(676), respectively) | **(1,697)** | (1,010) |
| Adjustment for gains realized in net income (net of tax of $(123) and $(331), respectively)(1) (3) | **(186)** | (503) |
| Benefit plans: | | |
| Amortization of pension net loss, transition asset and prior service credit (net of tax of $98 and $176, repectively)(2)(3) | **150** | 265 |
| Unrecognized pension net (loss) gain (net of tax of $(260) and $993, respectively) | **(395)** | 1,544 |
| Change in deferred compensation plan (net of tax of $(8) and $(32), respectively) | **(13)** | (49) |
| Total other comprehensive (loss) income | **(2,141)** | 247 |
| Total comprehensive income | **$ 1,496** | $ 87 |

(1) Gross amounts are included in investment securities gains on the consolidated statements of income in total other operating income.

(2) Gross amounts are included in the computation of net periodic benefit cost and are included in employee benefits on the consolidated statements of income in total other operating expenses.

(3) Income tax amounts are included in provision for income taxes on the consolidated statements of income.

See accompanying notes to consolidated financial statements.

# CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
## Years Ended December 31, 2016 and 2015

(in thousands except for share and per share data)

| | Common Stock | Surplus | Undivided Profits | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| **Balance, January 1, 2015** | $ 998 | $ 70,533 | $ 30,529 | $ (2,280) | $ (1,421) | $ 98,359 |
| Net loss | - | - | (160) | - | - | (160) |
| Other comprehensive income, net of taxes | - | - | - | 247 | - | 247 |
| Cash dividends declared ($1.65 per share) | - | - | (3,222) | - | - | (3,222) |
| Treasury stock retired (2,100 shares) | - | (91) | - | - | 91 | - |
| Treasury stock purchased (7,358 shares) | - | - | - | - | (349) | (349) |
| Vested restricted shares at $40 (900 shares), including | | | | | | - |
| compensation expense of $92 | - | 92 | - | - | - | 92 |
| **Balance, December 31, 2015** | 998 | 70,534 | 27,147 | (2,033) | (1,679) | 94,967 |
| Net income | - | - | 3,637 | - | - | 3,637 |
| Other comprehensive loss, net of taxes | - | - | | (2,141) | - | (2,141) |
| Cash dividends paid ($1.65 per share) | - | - | (3,219) | - | - | (3,219) |
| Treasury stock retired (4,462 shares) | - | (212) | - | - | 212 | - |
| Treasury stock purchased (802 shares) | - | - | - | - | (37) | (37) |
| Vested restricted shares at $40 per share (1,962 shares), including compensation expense of $150 | - | 150 | - | - | - | 150 |
| **Balance, December 31, 2016** | $ 998 | $ 70,472 | $ 27,565 | $ (4,174) | $ (1,504) | $ 93,357 |

See accompanying notes to consolidated statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

**Years Ended December 31, 2016 and 2015**

(dollars in thousands)

| | 2016 | 2015 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net income (loss) | **$ 3,637** | $ (160) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Provision for loan losses | **1,792** | 5,885 |
| Depreciation and amortization | **720** | 616 |
| Amortization of intangibles | **286** | 286 |
| Deferred income tax benefit | **(1,370)** | (1,158) |
| Investment securities gains | **(309)** | (834) |
| Restricted stock expense | **150** | 92 |
| Net loss on sale of other real estate owned, including writedowns | **-** | 535 |
| Net amortization of investment premiums | **546** | 266 |
| Net earnings on bank-owned life insurance | **(724)** | (725) |
| (Increase) decrease in accrued interest receivable | **(108)** | 25 |
| Increase (decrease) in other assets | **1,862** | (181) |
| Increase in other liabilities | **1,041** | 2,369 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | **7,523** | 7,016 |
| **INVESTING ACTIVITIES** | | |
| Purchases of investment securities available-for-sale | **(57,430)** | (102,110) |
| Proceeds from sales, maturities and calls of investment securities available-for-sale | **77,023** | 112,673 |
| Purchases of restricted investment in bank stocks | **(957)** | (63) |
| Net increase in loans | **(99,080)** | (109,021) |
| Purchases of premises and equipment | **(504)** | (1,212) |
| Proceeds from sale of other real estate owned | **-** | 1,769 |
| NET CASH USED IN INVESTING ACTIVITIES | **(80,948)** | (97,964) |
| **FINANCING ACTIVITIES** | | |
| Net increase in deposits | **73,478** | 100,636 |
| Net increase in short-term borrowings | **25,000** | - |
| Repayments of long-term debt | **(10,050)** | (46) |
| Cash dividends paid | **(3,219)** | (3,222) |
| Net purchases of treasury stock | **(37)** | (349) |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | **85,172** | 97,019 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | **11,747** | 6,071 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | **15,591** | 9,520 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | **$ 27,338** | $ 15,591 |
| Supplementary Cash Flow Information | | |
| Interest paid | **$ 4,190** | $ 4,161 |
| Income taxes paid | **665** | 665 |
| Supplementary Schedule of Non Cash Investing Activities | | |
| Loans transfered to other real estate owned | **$ 1,585** | $ - |

See accompanying notes to consolidated financial statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1. Summary of Significant Accounting Policies**

**Nature of Operations**

Orange County Bancorp, Inc. (the Parent Company) provides full-service commercial and consumer banking to individuals, small businesses and local municipal governments as well as trust and investment services through its wholly-owned subsidiary, Orange Bank & Trust Company (the Bank). On November 16, 2012, the Parent Company purchased Hudson Valley Investment Advisors (HVIA), a Registered Investment Advisor, to compliment the trust and investment services offered through the Bank. Collectively, these entities are referred to herein as the "Company." The Company is headquartered in Middletown, New York with ten locations in Orange County, New York, one in Dutchess County, New York, four in Westchester County, New York and one in Rockland County, New York.

**Basis of Financial Statements**

The consolidated financial statements have been prepared, in all material respects, in conformity with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of the Parent Company, the Bank, and, HVIA. All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the determination of other than temporary impairment on investment securities and the valuation of goodwill.

Assets held by the Trust & Investment Division in an agency or fiduciary capacity for its customers are excluded from the consolidated financial statements since they do not constitute assets of the Company. Assets held by the Trust & Investment Division amounted to $298,458,000 and $276,081,000 at December 31, 2016 and 2015, respectively. Income from fiduciary activities is recognized on the accrual method.

Certain amounts previously reported have been reclassified, when necessary, to conform to the current year's consolidated financial statement presentation. The reclassifications had no effect on net income or total stockholders' equity.

The Company has evaluated events and transactions occurring subsequent to the consolidated statement of condition date of December 31, 2016 for items that should potentially be recognized or disclosed in the consolidated financial statements. The evaluation was conducted through April 27, 2017 the date these consolidated financial statements were available to be issued.

**Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, balances due from banks, and federal funds sold, all of which mature within ninety days.

**Investment Securities**

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

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the securities, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) management does not expect to recover the entire amortized cost basis. GAAP specifies that (a) if an entity does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive (loss) income. Gains and losses on the sale of individual securities are recorded on the trade date and are determined using the specific identification method.

**Restricted Investment in Bank Stocks**

Restricted investment in bank stocks which represents required investments in the common stock of correspondent banks is carried at cost as of December 31, 2016 and 2015 and consists primarily of the common stock of the Federal Home Loan Bank of New York (FHLB) and the Federal Reserve Bank.

Management evaluates the restricted investment in bank stocks for impairment in accordance with Accounting Standard Codification (ASC) Topic 942, *Financial Services – Depository and Lending*. Management's determination of whether these investments are impaired is based on the assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted; (2)

commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the correspondent bank.

Management believes no impairment charge was necessary related to the restricted investment in bank stocks during 2016 or 2015. However, security impairment analysis is completed quarterly and the determination that no impairment has occurred during those years is no assurance that impairment may not occur in future periods.

**Loans and Allowance for Loan Losses**

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans in Orange County. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

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

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

The accrual of interest on commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. The accrual of interest on residential real estate loans and home equity loans is discontinued at the time the loan is 180 days past due unless the credit is well-secured and in the process of collection. Consumer loans are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

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

The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses (allowance) represents management's estimate of losses inherent in the loan portfolio as of the consolidated statement of condition date and is recorded as a reduction to loans. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated statement of condition. The amount of the reserve for unfunded lending commitments is not material to the consolidated financial statements.

The allowance for loan losses is established as losses are estimated to have occurred in the loan portfolio. The allowance for loan losses is recorded through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of the loan. The general component covers non-classified loans and is based on historical loss rates, adjusted for qualitative factors. These qualitative factors include:

- changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses;
- changes in international, national, regional and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments;
- changes in the nature and volume of the portfolio and in the terms of loans;
- changes in the experience, ability and depth of lending management and other relevant staff;
- changes in the volume and severity of past due loans, the volume of nonaccrual loans and the volume and severity of adversely classified or graded loans;
- changes in the quality of the Bank's loan review system;
- changes in the value of underlying collateral for collateral-dependent loans;
- the existence and effect of any concentrations of credit, and changes in the level of such concentration; and,
- the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio.

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

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum values have been established by the Bank and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, collateral appraisals, etc.

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

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

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

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

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

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

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

In underwriting commercial real estate construction loans, the Bank performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, the reliability and predictability of the cash flow generated by the project using feasibility studies, market data, etc.

Appraisals on properties securing commercial real estate construction loans originated by the Bank are performed by independent appraisers.

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

**Residential Real Estate Lending –** One- to four-family residential mortgage loan originations are generated by the Bank's marketing efforts, its present customers, walk-in customers and referrals. These loans originate primarily within the Bank's market area or with customers primarily from the market area.

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

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

Residential real estate loans generally present a lower level of risk than other types of loans because they are secured by the borrower's primary residence.

**Home Equity Lending –** The Bank originates home equity lines of credit and closed-end loans primarily within the Bank's market area or with customers primarily from the market area.

Home equity lines and loans are secured by the borrower's primary residence with a maximum loan-to-value of 85% and a maximum term of 15 years on home equity loans and a 10-year draw period followed by a 15-year repayment period for home equity lines.

In underwriting home equity lines and loans, a thorough analysis of the borrower's financial ability to repay the loan as agreed is performed. The ability to repay shall be determined by the borrower's employment history, current financial conditions, and credit background. The analysis is based primarily on the customer's ability to repay and secondarily on the collateral or security.

Home equity lines and loans generally present a lower level of risk than other types of consumer loans because they are secured by the borrower's primary residence.

The subordinate nature of some home equity lines and loans may make these loans of higher risk than other residential real estate loans.

**Consumer Lending –** The Bank offers a variety of secured and unsecured consumer loans, including vehicle, loans secured by savings deposits as well as other types of consumer loans.

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

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

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

A specific allocation within the allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of substantially all of the Bank's impaired loans are measured based on the estimated fair value of the loan's collateral.

For commercial loans secured by real estate, estimated fair values of collateral are determined primarily through third-party appraisals. When real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

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

Large groups of smaller balance homogeneous loans, including commercial and commercial real estate loans not considered individually impaired, are collectively evaluated for impairment.

Loans whose terms are modified are classified as troubled debt restructurings if the Bank grants such borrowers concessions that it would not otherwise consider and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate, continuance of a below market interest rate or an extension of a loan's stated maturity date. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

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

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or

liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, federal regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses and may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the level of the allowance for losses is adequate at December 31, 2016 and 2015.

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

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under commercial lines of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

**Premises and Equipment**

Land is carried at cost. Premises and equipment, including leasehold improvements, are carried at cost net of accumulated depreciation and amortization. Depreciation is computed on the straight-line and double declining balance methods over the estimated useful lives of the assets. Leasehold improvements are amortized over the terms of the leases or the estimated useful lives of the assets, whichever is shorter. Occupancy expense includes repairs and maintenance and all other expenses related to the operation of the premises. The estimated useful lives for significant property and equipment categories are as follows:

| | |
|---|---|
| Buildings and improvements | 8 to 50 years |
| Furniture and equipment | 3 to 10 years |

**Other Real Estate Owned**

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value, less costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are adjusted to their fair value, less costs to sell as necessary, but shall not exceed their cost basis. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from other real estate owned.

**Cash Surrender Value of Bank-Owned Life Insurance**

The Bank maintains nonqualified compensation plans for selected Directors and Officers. To fund the benefits under these plans, the Bank is the owner of single premium life insurance policies on participants in the nonqualified retirement plans. Investment in bank-owned life insurance policies was used to finance the nonqualified compensation plans and to provide tax-exempt income to the Company. This life insurance investment is carried at the cash surrender value of the underlying policies. Income from the increase in cash surrender value is included in other operating income on the consolidated statement of income.

ASC Topic 715, *Compensation – Retirement Benefits,* requires a liability to be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability is based on either the post-employment benefit cost for continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. The Bank's liability is based on the post-employment benefit cost for continuing life insurance. The Bank incurred approximately $57,000 and $53,000 of expense in 2016 and 2015, respectively, related to this accounting pronouncement.

**Goodwill and Intangible Assets**

Goodwill represents the excess of the purchase price over the underlying fair value of assets acquired less liabilities assumed. The Company assesses goodwill for impairment annually as of October 1 at the reporting unit level. If certain events occur which indicate goodwill might be impaired between annual tests, goodwill must be tested for impairment when such events occur. In making this assessment, the Company considers a number of factors including operating results, business plans, economic projections, anticipated futures cash flows, current market data, etc. There are inherent uncertainties related to these factors and judgment must be used in applying them to the analysis of goodwill impairment. Changes in economic and operating conditions could result in goodwill impairment in future periods. Management determined that the fair value of the reporting unit was greater than its carrying amount, thus, no impairment of goodwill exists, as of December 31, 2015 and 2014. Intangible assets are evaluated for impairment if events and circumstances indicate a possible impairment. Intangible assets are being amortized on a straight-line basis over fifteen years. Intangible amortization expense of $286,000 was recorded in 2016 and 2015, respectively. Intangible amortization expected for the succeeding five years beginning 2017 through 2021 is estimated to be $286,000 per year and $1,690,000 in total for years after 2021.

**Advertising Costs**

The Company follows the policy of charging the costs of advertising to expense as incurred.

**Income Taxes**

The Company accounts for income taxes in accordance with income tax accounting guidance ASC Topic 740.

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net

deferred tax asset or liability is based on the tax effects of the differences between the book and tax basis of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.
Uncertain tax positions are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the term sustained upon examination also includes resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances and information available at the reporting date and is subject to management's judgment.

The Company recognizes interest and penalties on income taxes as a component of income tax expense.

Years that remain open for potential review by taxing authorities are 2013 through 2016.

**Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Earnings (loss) per Share**

Earnings (loss) per share is computed by dividing net income by the weighted average number of shares outstanding during the year. The average number of shares outstanding during 2016 and 2015 was 1,956,306 and 1,957,016, respectively. The Company currently maintains a simple capital structure, thus there are no dilutive effects on earnings (loss) per share.

**Accumulated Other Comprehensive Loss**

The components of the accumulated other comprehensive loss, net of taxes, as of December 31, 2016 and 2015 are as follows (in thousands):

| | Unrealized (Loss) gains on Securities | Pension Plan Liability | Deferred Compensation Liability | Accumulated Other Comprehensive Loss |
|---|---|---|---|---|
| **Balance – December 31, 2016** | $(525) | $(3,730) | $81 | $(4,174) |
| Balance – December 31, 2015 | $1,359 | $(3,484) | $92 | $(2,033) |

Comprehensive income consists of net income (loss) and other comprehensive (loss) income. Other comprehensive (loss) income includes changes in unrealized gains and losses on securities available for sale arising during the period and reclassification adjustments for realized gains and losses on securities available for sale included in net income. The Company has unfunded noncontributory defined benefit Plans for directors and certain executive officers and other postretirement benefit Plans covering full-time employees. These Plans utilize assumptions and methods to calculate the fair value of Plan assets and recognizing the overfunded and underfunded status of the Plans on its consolidated balance sheet. Gains and losses, prior service costs and credits are recognized in other comprehensive income, net of tax, until they are amortized, or immediately upon curtailment.

**Pension Plan**

The Bank has a non-contributory defined-benefit pension plan covering substantially all employees meeting certain eligibility requirements which provides benefits upon reaching normal retirement age. Normal retirement age is 62 for employees hired prior to October 1, 2006 and 65 for employees hired subsequently. The Bank's funding policy is to contribute annually an amount sufficient to satisfy the minimum funding requirements of ERISA, but not greater than the maximum amount that can be deducted for federal income tax purposes. Contributions are intended to provide not only benefits attributed to service to-date, but also for benefits expected to be earned in the future.

The Bank follows ASC Topic 715, Compensation - Retirement Benefits, which requires an employer to recognize an asset or liability for the overfunded or underfunded status of its defined benefit plans. The overfunded or underfunded status is to be measured solely as the difference between the fair value of plan assets and the projected benefit obligation. In addition, any change in a plan's funded status must be recognized in comprehensive income in the year in which it occurs.

The compensation cost of an employee's pension benefit is recognized on the projected unit credit method over the employee's approximate service period. The aggregate cost method is utilized for funding purposes.

**Note 2. Investment Securities**

The amortized cost and fair value of investment securities at December 31, 2016 and 2015 were as follows:

| (in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **Available-for-sale December 31, 2016** | | | | |
| U.S. government agencies | **$ 89,413** | **$ 456** | **$ 909** | **$ 88,960** |
| Mortgage-backed securities | **117,098** | **272** | **1,550** | **115,820** |
| Obligations of states and political subdivisions | **73,642** | **1,211** | **350** | **74,503** |
| Total debt securities | **$ 280,153** | **$ 1,939** | **$ 2,809** | **$ 279,283** |
| **Available-for-sale December 31, 2015** | | | | |
| U.S. government agencies | $ 109,781 | $ 698 | $ 603 | $ 109,876 |
| Mortgage-backed securities | 114,976 | 714 | 884 | 114,806 |
| Obligations of states and political subdivisions | 77,819 | 2,354 | 26 | 80,147 |
| Total debt securities | $ 302,576 | $ 3,766 | $ 1,513 | $ 304,829 |

The following table shows gross unrealized losses on investment securities, segregated by category and length of time in continuous loss position, as of

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| (in thousands) | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| **Available-for-sale December 31, 2016** | | | | | | |
| U.S. government agencies | **$ 51,384** | **$ 752** | **$ 13,413** | **$ 158** | **$ 64,797** | **$ 910** |
| Mortgage-backed securities | **92,127** | **1,480** | **3,244** | **69** | **95,371** | **1,549** |
| Obligations of states and political subdivisions | **22,451** | **347** | **116** | **3** | **22,567** | **350** |
| Total debt securities | **$ 165,962** | **$ 2,579** | **$ 16,773** | **$ 230** | **$ 182,735** | **$ 2,809** |
| **Available-for-sale December 31, 2015** | | | | | | |
| U.S. government agencies | $ 35,162 | $ 144 | $ 37,841 | $ 459 | $ 73,003 | $ 603 |
| Mortgage-backed securities | 61,759 | 652 | 11,972 | 232 | 73,731 | 884 |
| Obligations of states and political subdivisions | 6,053 | 26 | - | - | 6,053 | 26 |
| Total debt securities | $ 102,974 | $ 822 | $ 49,813 | $ 691 | $ 152,787 | $ 1,513 |

Mortgage-backed securities are issued by FNMA, FHMC, and GNMA and consist of residential mortgages.

Obligations of states and political subdivisions consist of general obligations of municipalities in the state of New York.

There were 13 U.S. government agency securities with unrealized losses of less than 12 months at December 31, 2016 and 7 at December 31, 2015. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the securities. The securities in this category had unrealized losses of 1.4% of amortized cost at December 31, 2016. There were 3 U.S. government agency securities with unrealized losses greater than 12 months at December 31, 2016 and 9 at December 31, 2015. The securities in this category had unrealized losses of 1.2% and 1.2% of amortized cost at December 31, 2016 and 2015, respectivley. These losses relate principally to changes in interest rates subsequent to the acquisition of the securities.

The total number of mortgage-backed securities with unrealized losses of less than 12 months was 27 and 17 at December 31, 2016 and 2015, respectively. The securities in this category had unrealized losses of 1.6% and 1.1% of amortized cost at December 31, 2016 and 2015, respectively. There were 2 mortgage-backed securities with an unrealized loss greater than 12 months at December 31, 2016 and 4 at December 31, 2015. The securities in this category had unrealized losses of 2.1% and 2.0% of amortized cost at December 31, 2016 and 2015, respectively. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the securities.

There were 85 obligation of states and political subdivisions with an unrealized loss of less than 12 months at December 31, 2016 and 20 at December 31, 2015. The securities in this category had unrealized losses of 1.5% and 0.4% of amortized cost at Decmber 31, 2016 and 2015, respectively. There was 1 obligation of states and political subdivisions with an unrealized loss greater than 12 months at December 31, 2016 and zero at December 31, 2015. The securities in this category had an unrealized loss of 2.5% of amortized cost at December 31, 2016. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of specific securities.

Management routinely sells securities from its available for sale portfolio in an effort to manage and allocate the portfolio. At December 31, 2016, management had not identified any securities with an unrealized loss that it intended to sell, or would be required to sell. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the securities, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) management does not expect to recover the entire amortized cost basis. No securities were deemed to be other-than-temporarily impaired.

The amortized cost and fair value of debt securities as of December 31, 2016 by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands).

| | Available-for-sale | |
|---|---|---|
| | Amortized Cost | Fair Value |
| Due in one year or less | $ 56,404 | $ 46,673 |
| Due after one through five years | 70,871 | 71,534 |
| Due after five through ten years | 47,050 | 46,883 |
| Due after ten years | 2,050 | 2,050 |
| | 176,375 | 167,140 |
| Mortgage-backed securities | 103,778 | 112,143 |
| Total debt securities | $ 280,153 | $ 279,283 |

Debt securities with a carrying value of $142,305,000 and $130,441,000 were pledged to secure public deposits at December 31, 2016 and 2015, respectively. Proceeds from sales of investments in debt securities during 2016 and 2015 were $15,794,000 and $54,856,000, respectively. Gross gains in those years were $309,000 and $884,000, respectively. Gross losses were $0 and $50,000 in 2016 and 2015 respectively.

**Note 3. Loans**

The following table presents the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard, doubtful and loss within the Company's internal risk rating system as of December 31, 2016 and 2015:

| (in thousands) | Pass | Special Mention | Substandard | Doubtful | Loss | Total |
|---|---|---|---|---|---|---|
| **December 31, 2016** | | | | | | |
| Commercial and industrial | **$ 96,863** | **$ 4,134** | **$ 1,706** | **$ -** | **$ -** | **$ 102,703** |
| Commercial real estate | **341,759** | **4,333** | **12,906** | **-** | **-** | **358,998** |
| Commercial real estate - construction | **24,761** | **-** | **274** | **-** | **-** | **25,035** |
| Residential real estate | **44,309** | **-** | **521** | **-** | **-** | **44,830** |
| Home equity | **9,667** | **-** | **131** | **-** | **-** | **9,798** |
| Consumer | **502** | **-** | **-** | **-** | **-** | **502** |
| Total | **$ 517,861** | **$ 8,467** | **$ 15,538** | **$ -** | **$ -** | **$ 541,866** |

| (in thousands) | Pass | Special Mention | Substandard | Doubtful | Loss | Total |
|---|---|---|---|---|---|---|
| December 31, 2015 | | | | | | |
| Commercial and industrial | $ 90,301 | $ 378 | $ 3,872 | $ - | $ - | $ 94,551 |
| Commercial real estate | 255,177 | 4,849 | 16,301 | - | - | 276,327 |
| Commercial real estate - construction | 20,601 | - | 508 | - | - | 21,109 |
| Residential real estate | 41,418 | 133 | 538 | - | - | 42,089 |
| Home equity | 8,833 | - | 262 | - | - | 9,095 |
| Consumer | 1,200 | - | - | - | - | 1,200 |
| Total | $ 417,530 | $ 5,360 | $ 21,481 | $ - | $ - | $ 444,371 |

The following table summarizes information in regards to impaired loans by loan portfolio class as of December 31, 2016 and 2015:

| | Impaired loans with Allowance | | | Impaired loans with No Allowance | |
|---|---|---|---|---|---|
| (in thousands) | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance |
| **December 31, 2016** | | | | | |
| Commercial and industrial | **$ 1,194** | **$ 1,194** | **$ 490** | **$ 95** | **$ 95** |
| Commercial real estate | **9,314** | **9,314** | **607** | **7,808** | **7,807** |
| Commercial construction | **275** | **275** | **55** | **-** | **-** |
| Residential real estate | **443** | **443** | **42** | **77** | **77** |
| Home equity | **57** | **57** | **8** | **74** | **74** |
| Total | **$ 11,283** | **$ 11,283** | **$ 1,202** | **$ 8,054** | **$ 8,053** |
| December 31, 2015 | | | | | |
| Commercial and industrial | $ 2,148 | $ 2,241 | $ 1,643 | $ 1,150 | $ 1,327 |
| Commercial real estate | 9,245 | 9,923 | 479 | 8,754 | 9,846 |
| Residential real estate | 459 | 462 | 43 | 95 | 100 |
| Home equity | - | - | - | 247 | 353 |
| Total | $ 11,852 | $ 12,626 | $ 2,165 | $ 10,246 | $ 11,626 |

The following table summarizes information relative to average impaired loans and related interest income by loan portfolio class for the years ended December 31, 2016 and 2015:

| | Impaired loans with allowance | | Impaired loans with No allowance | |
|---|---|---|---|---|
| (in thousands) | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income |
| **December 31, 2016** | | | | |
| Commercial and industrial | **$ 1,194** | **$ 43** | **$ 95** | **$ 3** |
| Commercial real estate | **9,314** | **495** | **7,807** | **1,298** |
| Commercial construction | **275** | **9** | **-** | **-** |
| Residential real estate | **443** | **-** | **77** | **6** |
| Home equity | **57** | **1** | **74** | **3** |
| Total | **$ 11,283** | **$ 548** | **$ 8,053** | **$ 1,310** |
| December 31, 2015 | | | | |
| Commercial and industrial | $ 2,610 | $ 143 | $ 1,792 | $ 79 |
| Commercial real estate | 6,447 | 287 | 9,597 | 436 |
| Residential real estate | 231 | 10 | 223 | 6 |
| Home equity | 15 | - | 249 | 16 |
| Total | $ 9,303 | $ 440 | $ 11,861 | $ 537 |

The following table presents nonaccrual loans by classes of the loan portfolio as of December 31, 2016 and 2015:

| (in thousands) | 2016 | 2015 |
|---|---|---|
| Commercial and industrial | $ 1,073 | $ 2,322 |
| Commercial real estate | 7,650 | 8,313 |
| Residential real estate | 521 | 538 |
| Home equity | 131 | 187 |
| Total | $ 9,375 | $ 11,360 |

The performance and credit quality of the loan portfolio is also monitored by the analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the past due status as of December 31, 2016 and 2015:

| (in thousands) | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans Receivable | Loans Receivable > 90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| **December 31, 2016** | | | | | | | |
| Commercial and industrial | $ - | $ - | $ 1,073 | $ 1,073 | $ 101,630 | $ 102,703 | $ - |
| Commercial real estate | - | - | 2,005 | 2,005 | 356,993 | 358,998 | - |
| Commercial real estate-construction | - | - | - | - | 25,035 | 25,035 | - |
| Residential real estate | 77 | - | 1,101 | 1,178 | 43,652 | 44,830 | 658 |
| Home equity | 168 | 74 | 117 | 359 | 9,439 | 9,798 | - |
| Consumer | 1 | - | - | 1 | 501 | 502 | - |
| Total | $ 246 | $ 74 | $ 4,296 | $ 4,616 | $ 537,250 | $ 541,866 | $ 658 |
| **December 31, 2015** | | | | | | | |
| Commercial and industrial | $ 727 | $ - | $ 40 | $ 767 | $ 93,784 | $ 94,551 | $ - |
| Commercial real estate | 827 | 819 | 4,229 | 5,875 | 270,452 | 276,327 | - |
| Commercial real estate-construction | - | - | - | - | 21,109 | 21,109 | - |
| Residential real estate | 290 | - | 689 | 979 | 41,110 | 42,089 | 151 |
| Home equity | - | - | 138 | 138 | 8,957 | 9,095 | 75 |
| Consumer | - | - | - | - | 1,200 | 1,200 | - |
| Total | $ 1,844 | $ 819 | $ 5,096 | $ 7,759 | $ 436,612 | $ 444,371 | $ 226 |

The following tables summarize the allowance for loan losses and recorded investment in financing receivables:

| (in thousands) | Commercial and Industrial | Commercial Real Estate | Commercial Real Estate Construction | Residential Real Estate | Home Equity | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| **As of December 31, 2016** | | | | | | | | |
| **Allowance for loan losses** | | | | | | | | |
| Beginning balance - January 1, 2016 | $ 2,798 | $ 3,466 | $ 600 | $ 206 | $ 22 | $ 14 | $ 47 | $ 7,153 |
| Charge-offs | (1,251) | (146) | - | (82) | (21) | (39) | - | (1,539) |
| Recoveries | 239 | 70 | 4 | - | 13 | 6 | - | 332 |
| Provisions (benefits) | 329 | 1,453 | (92) | 100 | 30 | 20 | (47) | 1,793 |
| Ending balance | $ 2,115 | $ 4,843 | $ 512 | $ 224 | $ 44 | $ 1 | $ - | $ 7,739 |
| Ending balance: individually evaluated for impairment | $ 490 | $ 607 | $ 55 | $ 42 | $ 8 | $ - | $ - | $ 1,202 |
| Ending balance: collectively evaluated for impairment | $ 1,625 | $ 4,236 | $ 457 | $ 182 | $ 36 | $ 1 | $ - | $ 6,537 |
| **Loans receivables** | | | | | | | | |
| Ending balance | $ 102,703 | $ 358,998 | $ 25,035 | $ 44,830 | $ 9,798 | $ 502 | $ - | $ 541,866 |
| Ending balance: individually evaluated for impairment | $ 1,289 | $ 17,121 | $ 275 | $ 521 | $ 131 | $ - | $ - | $ 19,337 |
| Ending balance: collectively evaluated for impairment | $ 101,414 | $ 341,877 | $ 24,760 | $ 44,309 | $ 9,667 | $ 502 | $ - | $ 522,529 |

(in thousands)

| As of December 31, 2015 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Allowance for loan losses** | | | | | | | | |
| Beginning balance - January 1, 2015 | $ 1,471 | $ 2,521 | $ 252 | $ 377 | $ 76 | $ 17 | $ 71 | $ 4,785 |
| Charge-offs | (1,697) | (464) | (1,265) | (62) | (45) | (37) | - | (3,570) |
| Recoveries | 38 | - | - | 1 | - | 14 | - | 53 |
| Provisions (benefits) | 2,986 | 1,409 | 1,613 | (110) | (9) | 20 | (24) | 5,885 |
| Ending balance | $ 2,798 | $ 3,466 | $ 600 | $ 206 | $ 22 | $ 14 | $ 47 | $ 7,153 |
| Ending balance: individually evaluated for impairment | $ 1,643 | $ 479 | $ - | $ 43 | $ - | $ - | $ - | $ 2,165 |
| Ending balance: collectively evaluated for impairment | $ 1,155 | $ 2,987 | $ 600 | $ 163 | $ 22 | $ 14 | $ 47 | $ 4,988 |
| **Loans receivables** | | | | | | | | |
| Ending balance | $ 94,551 | $ 276,327 | $ 21,109 | $ 42,089 | $ 9,095 | $ 1,200 | $ - | $ 444,371 |
| Ending balance: individually evaluated for impairment | $ 3,298 | $ 18,000 | $ - | $ 553 | $ 247 | $ - | $ - | $ 22,098 |
| Ending balance: collectively evaluated for impairment | $ 91,253 | $ 258,327 | $ 21,109 | $ 41,536 | $ 8,848 | $ 1,200 | $ - | $ 422,273 |

The recorded investments in troubled debt restructured loans at December 31, 2016 and 2015 are as follows (in thousands):

| | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Current Recorded Investment |
|---|---|---|---|
| **December 31, 2016** | | | |
| Commercial and industrial | **$ 580** | **$ 580** | **$ 256** |
| Commercial real estate | **18,419** | **18,419** | **17,210** |
| Home Equity | **75** | **75** | **75** |
| | **$ 19,074** | **$ 19,074** | **$ 17,541** |
| December 31, 2015 | | | |
| Commercial and industrial | $ 3,948 | $ 3,948 | $ 3,284 |
| Commerical real estate | $ 20,246 | $ 20,246 | $ 17,688 |
| Home Equity | 75 | 75 | 75 |
| | $ 24,269 | $ 24,269 | $ 21,047 |

Troubled debt restructured loans at December 31, 2016 totaled $17,541,000. There are two commercial and industrial and ten commercial real estate troubled debt restructured loans totaling $9,962,000, which are accruing and in compliance with the terms of the modification. There is one commercial and industrial, six commercial real estate and one home equity troubled debt restructed loans totaling $7,579,000, which are non-accruing. There are forbearance agreements on all loans currently classified as troubled debt restructures. The terms of the forebearance agreements resulted in below-market interest rates. In 2016, two loans were modified to defer principal and interest payments, extend terms and provide payment relief.

Troubled debt restructured loans at December 31, 2015 totaled $21,047,000. There are five commercial and industrial, ten commercial real estate and one home equity troubled debt restructured loans totaling $10,738,000 which are accruing and in compliance with the terms of the modification. There are six commercial and industrial and eight commercial real estate troubled debt restructed loans totaling $10,309,000 which are non-accruing. There are forbearance agreements on all loans currently classified as troubled debt restructures. The terms of the forebearance agreements resulted in below-market interest rates. In 2015, three loans were modified to defer principal and interest payments, extend terms and provide payment relief and three loans were modified to extend terms and provide payment relief.

The following table summarizes loans whose terms have been modified resulting in troubled debt restructurings during the years ended December 31, 2016 and 2015 (in thousands):

| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Current Recorded Investment |
|---|---|---|---|---|
| **2016** | | | | |
| Commercial real estate | **2** | **$ 6,489** | **$ 6,489** | **$ 6,431** |
| | **2** | **$ 6,489** | **$ 6,489** | **$ 6,431** |
| 2015 | | | | |
| Commercial and industrial | 4 | $ 1,660 | $ 1,660 | $ 1,425 |
| Commercial real estate | 2 | $ 5,310 | $ 5,310 | $ 5,250 |
| | 6 | $ 6,970 | $ 6,970 | $ 6,675 |

There were no loans that defaulted within twelve months of restructure during 2016 or 2015.

Loans in the process of foreclosure were $2,435,000 as of December 31, 2016.

Loans to certain directors and principal officers of the Company, including their immediate families and companies in which they are principal owners (more than 10%), amounted to $385,000 and $520,000 at December 31, 2016 and December 31, 2015. Activity for these loans for the years ended December 31, 2016 and 2015 are as follows (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Balance, beginning of year | **$ 520** | $ 645 |
| Additions | **-** | - |
| Repayments | **(135)** | (125) |
| Balance, end of year | **$ 385** | $ 520 |

**Note 4. Premises and Equipment**

Premises and equipment at December 31, 2016 and 2015 were as follows (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Land | **$ 3,152** | $ 3,192 |
| Buildings and improvements | **10,528** | 10,525 |
| Furniture and equipment | **5,080** | 4,687 |
| Leasehold improvements | **5,151** | 5,003 |
| | **23,911** | 23,407 |
| Accumulated depreciation and amortization | **(9,619)** | (9,023) |
| Premises and equipment, net | **$ 14,292** | $ 14,384 |

Depreciation and amortization included in operating expenses amounted to $720,000 in 2016 and $616,000 in 2015.

Certain premises are leased under agreements which are renewable for varying periods and are subject to minimum lease payments as well as additional rent. Rent expense for all operating leases was $587,000 in 2016 and $551,000 in 2015.

As of December 31, 2015 future minimum lease payments are as follows (in thousands):

| Years Ending December 31, | |
|---|---|
| 2017 | $ 533 |
| 2018 | 449 |
| 2019 | 223 |
| 2020 | 221 |
| 2021 | 173 |
| Thereafter | 1,319 |
| | $ 2,918 |

**Note 5. Deposits**

A summarized analysis of the Bank's deposits at December 31, 2016 and 2015 follows (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Demand deposits of individuals, partnerships and corporations | **$ 145,852** | $ 101,320 |
| NOW accounts of individuals, partnerships and corporations | **82,752** | 60,943 |
| Time and savings deposits of individuals, partnerships and corporations | **318,179** | 323,555 |
| Deposits of state and political subdivisions | **158,933** | 148,714 |
| Deposits of commercial banks and other depository institutions in the U.S. | **947** | 1,444 |
| Certified and official checks | **5,367** | 2,576 |
| Total deposits | **$ 712,030** | $ 638,552 |

Overdrawn accounts amounted to $113,000 and $226,000 at December 31, 2016 and 2015, respectively.

At December 31, 2016 and 2015, the Bank had $31,503,000 and $34,836,000, respectively, of time certificates of deposit of $250,000 or more.

Scheduled maturities of time certificates of deposit at December 31, 2016, were as follows (in thousands):

| Years Ending December 31, | |
|---|---|
| 2017 | $ 88,998 |
| 2018 | 8,901 |
| 2019 | 10,362 |
| 2020 | - |
| 2021 | - |
| | $ 108,261 |

Deposits of executive officers, directors and principal officers of the Company, including their immediate families and companies in which they are principal owners (more than 10%), amounted to $7,804,000 and $6,831,000 at December 31, 2016 and December 31, 2015, respectively.

**Note 6. Borrowings**

A summary of short-term borrowings as of December 31, 2016 and 2015 is as follows (in thousands):

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | Amount | Rate | Amount | Rate |
| Federal Home Loan Bank (FHLB) Overnight line of credit | $ 10,000 | 0.74% | $ - | 0.00% |
| FHLB fixed-rate advances maturing: | | | | |
| 2017 | 15,000 | 1.04% | - | 0.00% |
| Total short-term borrowings | $ 25,000 | 0.92% | $ - | 0.00% |

A summary of long-term debt as of December 31, 2016 and 2015 is as follows (in thousands):

| | 2016 | | 2015 | |
|---|---|---|---|---|
| FHLB fixed-rate advances maturing: | Amount | Rate | Amount | Rate |
| 2016 | $ - | 0.00% | $ 40,000 | 4.07% |
| 2017 | 30,000 | 4.03% | 30,000 | 4.03% |
| 2018 | 15,000 | 1.25% | - | 0.00% |
| 2019 | 15,000 | 1.40% | - | 0.00% |
| Note payable | 3,165 | 6.00% | 3,215 | 6.00% |
| Total long-term debt | $ 63,165 | 2.84% | $ 73,215 | 4.14% |

Short-term borrowings are primarily in the form of federal funds purchased, an overnight line of credit, or FHLB fixed-rate borrowings that mature in less than one year. During 2016 and 2015 the average short-term borrowings balance was $6,734,000 and $605,000, respectively, and the average interest rate was 0.88% and 0.41%, respectively. Long-term advances from the FHLB are in the form of fixed-rate term borrowings and convertible advances. A convertible advance allows the FHLB to convert the advance at a set future date.

The note payable is payable in monthly installments of $20,000 of principal and interest, is unsecured, and matures with a balloon payment in November 2019.

The Bank maintains a line of credit program with the FHLB with a maximum borrowing capacity of $88,800,000 as of December 31, 2016. To secure this line of credit, as well as other FHLB borrowings, the Bank is required to own stock in the FHLB and to pledge certain qualifying collateral, primarily in the form of securities and residential mortgages, under a security agreement and master repurchase agreement. The Bank owned $4,015,000 and $3,688,000 of FHLB stock as of December 31, 2016 and 2015, respectively.

At December 31, 2016 and 2015, the Bank may also borrow up to $5,000,000 under a line of credit with another correspondent bank on an unsecured basis. There were no advances under this line of credit at December 31, 2016 or 2015.

**Note 7. Income Taxes**

The provision (benefit) for income taxes was as follows for the years ended December 31, 2016 and 2015 (in thousands):

| | 2016 | 2015 |
|---|---|---|
| Current tax expense: | | |
| Federal | $ 1,916 | $ (666) |
| State | 175 | 73 |
| Total current tax expense | 2,091 | (593) |
| Deferred tax benefit | (1,370) | (1,158) |
| Total provision (benefit) for income taxes | $ 721 | $ (1,751) |

The following is a reconciliation of income tax (benefit) expense and the amount computed by applying the statutory federal income tax rate of 34% to income before income taxes (in thousands):

| | 2016 | 2015 |
|---|---|---|
| Tax expense at statutory rate | $ 1,482 | $ (650) |
| Increase (decrease) in taxes resulting from: | | |
| Net earnings on bank-owned life insurance | (246) | (247) |
| Tax-exempt municipal bond income | (784) | (923) |
| State income tax, net of federal tax benefit | 200 | (67) |
| Interest expense disallowed as a result of carrying tax-exempt bonds | 7 | 1 |
| Other | 62 | 135 |
| Total (benefit) provision for income tax | $ 721 | $ (1,751) |

Components of deferred tax assets and liabilities at December 31, 2016 and 2015 were as follows (in thousands):

| | 2016 | 2015 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ 2,902 | $ 2,664 |
| Reserve for unfunded commitments and other real estate owned | 235 | 57 |
| Deferred loan fees | 596 | 352 |
| Deferred compensation | 2,760 | 2,617 |
| Alternative minimum tax credit | 724 | 19 |
| Organization costs - holding company | 19 | 23 |
| Organization costs - HVIA | 40 | 43 |
| Available for sale securities | 346 | - |
| Contribution carryover | 31 | - |
| Defined benefit plan | 2,564 | 2,495 |
| | 10,217 | 8,270 |
| Deferred tax liabilities: | | |
| Intangible amortization | (571) | (420) |
| Accumulated depreciation | (214) | (305) |
| Accretion | (84) | (79) |
| Available for sale securities | - | (894) |
| | (869) | (1,698) |
| Net deferred tax asset | $ 9,348 | $ 6,572 |

The Company's net deferred tax asset at December 31, 2016 and 2015 is included in other assets on the consolidated statement of condition.

The Company did not have any uncertain tax positions at December 31, 2016 and 2015. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in income tax expense in the Consolidated Statements of Income.

**Note 8. Fair Value of Financial Instruments**

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

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Additional guidance is provided on determining when the volume and level of activity for the asset or liability has significantly decreased. The guidance also includes direction on identifying circumstances when a transaction may not be considered orderly.

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

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

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

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

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

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with

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

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2016 and 2015 are as follows (in thousands):

| | **Fair Value Measurements at December 31, 2016** | | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| **U.S. government agencies** | **$ 88,960** | **$ -** | **$ 88,960** | **$ -** |
| **Mortgage-backed securities** | **115,820** | **-** | **115,820** | **-** |
| **Obligations of states and political subdivisions** | **74,503** | **-** | **74,503** | **-** |
| **Total securities available for sale** | **$ 279,283** | **$ -** | **$ 279,283** | **$ -** |

| | Fair Value Measurements at December 31, 2015 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| U.S. government agencies | 109,876 | $ - | 109,876 | $ - |
| Mortgage-backed securities | 114,806 | - | 114,806 | - |
| Obligations of states and political subdivisions | 80,147 | - | 80,147 | - |
| Total securities available for sale | $ 304,829 | $ - | $ 304,829 | $ - |

For financial assets measured at fair value on a non-recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2016 and 2015 are as follows (in thousands):

| | **Fair Value Measurements at December 31, 2016** | | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| Impaired loans | **$ 10,081** | **$ -** | **$ -** | **$ 10,081** |

| | Fair Value Measurements at December 31, 2015 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Impaired loans | $ 9,687 | $ - | $ - | $ 9,687 |

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which Level 3 inputs have been used to determine fair value (in thousands):

| **December 31, 2016** | Fair Value Estimate | Valuation Technique | Unobservable Input | Range (Average) |
|---|---|---|---|---|
| Impaired loans | $ 10,080 | Appraisal of collateral (1) | Appraisal and liquidation adjustments (2) | 5-20% (13%) |

| December 31, 2015 | Fair Value Estimate | Valuation Technique | Unobservable Input | Range (Average) |
|---|---|---|---|---|
| Impaired loans | $ 9,687 | Appraisal of collateral (1) | Appraisal and liquidation adjustments (2) | 5-20% (13%) |

(1) Fair value is generally determine through independent appraisals of the underlying collateral that generally include various level 3 inputs which are not identifiable.

(2) Appraisals may be adjusted downward by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments and pension plan assets at December 31, 2016 and 2015:

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

The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values.

**Investment Securities Available for Sale and Pension Plan Assets**

The fair value of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the security's relationship to other benchmark quoted prices. The Company uses an independent service provider to provide matrix pricing. The Company did not have any Level 3 investment securities or pension plan assets at December 31, 2016 and 2015.

**Loans (Carried at Cost)**

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

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

Loans for which the Company has measured impairment are generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances less the valuation allowance.

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

The carrying amount of restricted investment in bank stocks approximates fair value and considers the limited marketability of such securities.

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

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

**Deposits (Carried at Cost)**

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

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

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

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

Fair values of Federal Home Loan Bank (FHLB) advances and other notes payable are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

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

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

The following presents the carrying amount, fair value, and placement in the fair value heirarchy of the Company's financial instruments at December 31, 2016 (in thousands):

| | December 31, 2016 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | |
| Cash and due from banks | $ 27,338 | $ 27,338 | $ 27,338 | $ - | $ - |
| Investment securities available for sale | 279,283 | 279,283 | - | 279,283 | - |
| Net loans | 534,127 | 532,449 | - | - | 532,449 |
| Accrued interest receivable | 2,580 | 2,580 | - | 2,580 | - |
| Restricted investment in bank stocks | 4,774 | 4,774 | - | 4,774 | - |
| Financial liabilities: | | | | | |
| Deposits | 712,030 | 713,728 | - | 713,728 | - |
| Long-term debt | 88,165 | 88,452 | - | 88,452 | - |
| Accrued interest payable | 335 | 335 | - | 335 | - |
| Off-balance sheet financial instruments | - | - | - | - | - |

The following presents the carrying amount and fair value of the Company's financial instruments at December 31, 2015 (in thousands):

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | |
| Cash and due from banks | $ 15,591 | $ 15,591 | $ 15,591 | $ - | $ - |
| Investment securities available for sale | 304,829 | 304,829 | - | 304,829 | - |
| Net loans | 437,218 | 439,326 | - | - | 439,326 |
| Accrued interest receivable | 2,472 | 2,472 | - | 2,472 | - |
| Restricted investment in bank stocks | 3,817 | 3,817 | - | 3,817 | - |
| Financial liabilities: | | | | | |
| Deposits | 638,552 | 638,481 | - | 638,481 | - |
| Long-term debt | 73,215 | 75,311 | - | 75,311 | - |
| Accrued interest payable | 499 | 499 | - | 499 | - |
| Off-balance sheet financial instruments | - | - | - | - | - |

**Note 9. Employee Benefit Plans**

**Pension Plan**

The following is a summary of changes in the projected benefit obligations and plan assets for the pension plan as of December 31, 2016 and 2015 (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Change in projected benefit obligation: | | |
| Beginning of year | **$ 23,848** | $ 26,771 |
| Service cost | **153** | 1,142 |
| Interest cost | **1,052** | 1,053 |
| Benefits paid | **(1,240)** | (1,169) |
| Actuarial (gain) loss | **959** | (1,371) |
| Curtailment gain | **-** | (2,578) |
| End of year | **$ 24,772** | $ 23,848 |
| Change in fair value of assets: | | |
| Beginning of year | **$ 17,774** | $ 18,789 |
| Contributions | **593** | 261 |
| Actual return on plan assets | **1,418** | (111) |
| Benefits paid and expenses | **(1,246)** | (1,165) |
| End of year | **$ 18,539** | $ 17,774 |

The funded status of the pension plan recognized in the Company's balance sheet was as follows (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Funded status at year end, included in other liabilities | **$ (6,233)** | $ (6,074) |

Amounts recognized in accumulated other comprehensive loss (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Total net actuarial loss | **$ (6,283)** | $ (5,924) |
| Transition asset | **267** | 314 |
| Prior service credit | **-** | - |
| Total included in accumulated other comprehensive loss (pretax) | **$ (6,016)** | $ (5,610) |

The estimated costs that will be amortized from accumulated other comprehensive loss into net periodic pension cost during the next fiscal year are as follows (in thousands):

| | |
|---|---|
| Amortization of net loss | **$ (490)** |
| Amortization of transition asset | **48** |
| Amortization of prior service credit | **-** |
| | **$ (442)** |

The components of the net periodic pension cost were as follows (in thousands):

| | **2016** | 2015 |
|---|---|---|
| Service cost | **$ 153** | $ 1,142 |
| Interest cost | **1,052** | 1,053 |
| Expected return on plan assets | **(1,108)** | (1,192) |
| Amortization of transition cost | **(48)** | (48) |
| Amortization of prior service credit | **-** | (12) |
| Amortization of net loss | **296** | 501 |
| Net periodic benefit cost | **$ 345** | $ 1,444 |
| Curtailment gain | **-** | (78) |
| Net periodic pension cost after curtailments | **$ 345** | $ 1,366 |
| Net loss (gain) | **$ 655** | $ (73) |
| Effect of Curtailment | **-** | (2,500) |
| Amortization of transition asset | **48** | 48 |
| Amortization of prior service credit | **-** | 12 |
| Amortization of net loss | **(296)** | (501) |
| Total amount recognized in other comprehensive (income) loss | **$ 407** | (3,014) |
| Total recognized in net periodic benefit cost and other comprehensive loss (income) | **$ 752** | $ (1,647) |

Assumptions used to determine the net periodic pension cost were as follows:

| | **2016** | 2015 |
|---|---|---|
| Discount rate | **4.55%** | 4.04% |
| Expected long-term rate of return on plan assets | **6.50%** | 6.50% |
| Rate of compensation increase | **0.00%** | 3.00% |

Assumptions used to determine the benefit obligations at December 31 were as follows:

| | **2016** | 2015 |
|---|---|---|
| Discount rate | **4.41%** | 4.55% |
| Rate of compensation increase | **0.00%** | 0.00% |

Pension benefits expected to be paid in each year from 2017 to 2021 are $1,257,000, $1,305,000, $1,310,000, $1,309,000, and $1,315,000, respectively. The aggregate pension benefits expected to be paid in the five years from 2021 to 2025 are $7,160,000. The accumulated benefit obligation for the pension plan was $24,772,000 as of December 31, 2016 and $23,848,000 as of December 31, 2015.

The investment strategy and investment policy for the retirement plan is to target the plan assets to contain 0-20% cash equivalents, 40-60% equity securities and 40-60% fixed income investments.

The pension plan weighted-average asset allocation at December 31, 2016 and 2015, by asset category were as follows:

| | **2016** | 2015 |
|---|---|---|
| Asset category: | | |
| Cash equivalents | **6.10%** | 5.20% |
| Equity securities | **47.90%** | 47.20% |
| Fixed income | **42.60%** | 43.90% |
| Other financial instruments | **3.40%** | 3.70% |
| Total | **100.00%** | 100.00% |

**Fair value measurements at December 31, 2016 are as follows:**

(in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash equivalents: | | | | |
| Foreign currencies | **$ 29** | **$ -** | **$ -** | **$ 29** |
| Short term investment funds | **-** | **92** | **-** | **92** |
| | **29** | **92** | **-** | **121** |
| Equities: | | | | |
| Common Stock | **3,956** | **-** | **-** | **3,956** |
| Depository Receipts | **116** | **-** | **-** | **116** |
| Commingled pension trust funds | **-** | **4,647** | **-** | **4,647** |
| | **4,072** | **4,647** | **-** | **8,719** |
| Fixed income securities: | | | | |
| Collateralized mortgage obligations | **-** | **188** | **-** | **188** |
| Commingled pension trust funds | **-** | **4,792** | **-** | **4,792** |
| Corporate Bonds | **-** | **850** | **-** | **850** |
| Federal National Mortgage Assoc | **-** | **172** | **-** | **172** |
| Government Securities | **-** | **2,904** | **-** | **2,904** |
| Mortgage Backed Securities | **-** | **10** | **-** | **10** |
| | **-** | **8,916** | **-** | **8,916** |
| Other investments | | | | |
| Commingled pension trust funds-realty | **-** | **-** | **783** | **783** |
| | **-** | **-** | **783** | **783** |
| Total investments | **$ 4,101** | **$ 13,655** | **$ 783** | **$ 18,539** |

Fair value measurements at December 31, 2015 are as follows:

(in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash equivalents: | | | | |
| Foreign currencies | $ 9 | $ - | $ - | $ 9 |
| Short term investment funds | - | 920 | - | 920 |
| | 9 | 920 | - | 929 |
| Equities: | | | | |
| Common Stock | 3,214 | - | - | 3,214 |
| Depository Receipts | 82 | - | - | 82 |
| Commingle pension trust funds | - | 2,593 | - | 2,593 |
| Exchange traded funds | 2,503 | - | - | 2,503 |
| | 5,799 | 2,593 | - | 8,392 |
| Fixed income securities: | | | | |
| Collateralized mortgage obligations | - | 149 | - | 149 |
| Commingled pension trust funds | - | 4,394 | - | 4,394 |
| Corporate Bonds | - | 845 | - | 845 |
| Federal Home Loan Mortgage Corp | - | 68 | - | 68 |
| Federal National Mortgage Assoc | - | 483 | - | 483 |
| Government National Mortgage Assoc II | - | 94 | - | 94 |
| Government Issues | - | 1,764 | - | 1,764 |
| | - | 7,797 | - | 7,797 |
| Other Investments | | | | |
| Commingled pension trust funds-realty | - | - | 656 | 656 |
| | | | 656 | 656 |
| Total investments | $ 5,808 | $ 11,310 | $ 656 | $ 17,774 |

The pension plan was closed to new participants and benefit accruals were frozen as of December 31, 2015.

The Company contributed $383,000 to the pension plan in 2017 and has not yet determined if any additional contributions will be made in 2017.

**Supplemental Executive Retirement Plan**

The Bank maintains a Supplemental Executive Retirement Plan for two former Chief Executive Officers to restore pension benefits that are limited due to Internal Revenue Service regulations. The benefits accrued under this plan were $792,000 and $812,000 as of December 31, 2016 and 2015. The Bank recorded expense of $59,000 and income of $60,000 in 2016 and 2015 in relation to this plan.

Supplemental benefits expected to be paid in each year from 2017 to 2021 are $79,000, $79,000, $79,000, $79,000, $79,000, respectively. The aggregate supplemental benefits expected to be paid in the five years from 2022 to 2026 are $396,000.

**Deferred Directors' Fee Plan**

The Bank and the Parent Company maintain unfunded Deferred Director’s Fee Plans within which each director may defer the receipt of meeting fees. The benefits accrued under these plans totaled $4,001,000 and $3,542,000 at December 31, 2016 and 2015. The Bank and the Parent Company recorded an expense of $515,000 and $518,000 in 2016 and 2015 in relation to these plans.

**Deferred Compensation Plan**

The Bank and HVIA maintain unfunded Deferred Compensation Plans for certain officers. The benefits accrued under these plans totaled $1,001,000 and $1,168,000 at December 31, 2016 and 2015. The Bank and HVIA recorded an expense of $69,000 and $183,000 in 2016 and 2015, respectively.

**Deferred Incentive Retirement Plan**

The Bank maintains an unfunded Deferred Incentive Retirement Plan for certain executive officers. The benefits accrued under this plan totaled $957,000 and $998,000 at December 31, 2016 and 2015. The Bank recorded an expense of $48,000 and $49,000 in 2016 and 2015, respectively.

**401(k) Savings Plan**

The Company has a 401(k) Plan (Plan) to provide retirement and incidental benefits for its employees. Employees may contribute up to 100% of their annual compensation to the Plan, limited to a maximum annual amount as set periodically by the Internal Revenue Service. Effective for Plan Years beginning January 1, 2016, the Company makes a safe harbor nonelective contribution equal to 3% of annual compensation for each eligible employee whether or not the employee elects to defer compensation to the plan. All safe harbor nonelective contributions vest immediately. In addition,effective for Plan Years beginning January, 2016, for those employees hired before April 1, 2016, the Plan provides for discretionary contributions according to the following schedule:

| Percentage of Compensation | Participant Age Range |
|---|---|
| 1.0% | Under age 35 |
| 2.0% | 35 years of age, but less than 45 |
| 5.0% | 45 years of age, but less than age 55 |
| 8.5% | 55 years of age or older |

Employees are eligible for the discretionary contribution after completing one year of service. All discretionary contributions vest immediately.

Discretionary contributions were $443,000 and $0 for 2016 and 2015, respectively.

**Restricted Stock Grants**

4,462 restricted shares of common stock were granted in 2016 to ten executive officers at a price of $47.60 per share. 20% or 889 shares were vested in 2016, with 20%, or 887 shares vesting in 2017, 20% or 886 shares vesting in 2018, 20% or 900 shares vesting in 2019 and 20% or 900 shares vesting in 2020. 2,100 restricted shares of common stock were granted in 2015 to seven executive officers at a price of $43.50 per share. 50% or 1,050 shares will vest in 2018 with the remaining shares to vest in 2019. 4,250 restricted shares of common stock were granted in 2014 to an executive officer of the Bank at a price of $40.00 per share. 50% or 2,125 shares vested in 2015, 25% or 1,062 shares will vest in 2016 and 25% or 1,063 shares will vest in 2017. 1,800 restricted shares of common stock were granted in 2013 to five executive officers of the Bank at a price of $40.00 per share. 50% of the shares will vest in 2016 with the remaining shares to vest in 2017. Two of the executives retired in 2014 and the vesting of those 900 shares were accelerated into 2014. Of the remaining 900 shares, 450 vested in 2016 and 450 will vest in 2017. Unamortized expense at December 31, 2016 was $150,000.

**Note 10. Regulatory Matters**

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. In July 2013, the federal banking agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on banking Supervision, commonly referred to as Basel Ill, that (i) introduced a new capital ratio pursuant to the prompt corrective action provisions, the common equity tier 1 capital to risk weighted assets ratio, (ii) increased the adequately capitalized and well capitalized thresholds for the Tier 1 risk based capital ratios to 6% and 8%, respectively, (iii) changed the treatment of certain capital components for determining Tier 1 and Tier 2 capital, and (iv) changed the risk weighting of certain assets and off balance sheet items in determining risk weighted assets. The new rules, which were effective January 1, 2015, also require that banks maintain a ··capital conservation buffer'" of 250 basis points in excess of the "minimum capital ratio." The minimum capital ratio is equal to the prompt corrective action adequately capitalized threshold ratio. The capital conservation buffer will be phased in over four years beginning on January 1, 2016, with a maximum buffer of 0.625% of risk weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. Failure to maintain the required capital conservation buffer will result in limitations on capital distributions and on discretionary bonuses to executive officers.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth below) of Tier 1 capital to average assets and of Tier 1 and total capital (as defined in the regulations) to risk weighted assets. Management believes, as of December 31, 2016, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2016, the most recent notification from the regulators categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

The actual and required capital amounts and ratios were as follows:

| | Actual | | For Capital Adequacy Purposes | | For Capital Adequacy Purposes with Capital Buffer | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **Company** | | | | | | | | |
| **As of December 31, 2016** | | | | | | | | |
| Common equity tier 1 capital ratio | **$ 90,570** | **15.33%** | **$ 26,580** | **≥4.5%** | **$ 30,272** | **≥5.125%** | **N/A** | **N/A** |
| Tier 1 captial ratio | **90,570** | **15.33** | **35,440** | **≥6.0%** | **39,132** | **≥6.625%** | **N/A** | **N/A** |
| Total capital ratio | **97,959** | **16.58** | **47,253** | **≥8.0%** | **50,945** | **≥8.625%** | **N/A** | **N/A** |
| Tier 1 leverage ratio | **90,570** | **9.81** | **36,920** | **≥4.0%** | **N/A** | **N/A** | **N/A** | **N/A** |
| As of December 31, 2015 | | | | | | | | |
| Common equity tier 1 capital ratio | $ 88,249 | 17.44% | $ 22,776 | ≥4.5% | N/A | N/A | N/A | N/A |
| Tier 1 captial ratio | 88,249 | 17.44 | 30,367 | ≥6.0% | N/A | N/A | N/A | N/A |
| Total capital ratio | 94,588 | 18.69 | 40,490 | ≥8.0% | N/A | N/A | N/A | N/A |
| Tier 1 leverage ratio | 88,249 | 10.96 | 32,210 | ≥4.0% | N/A | N/A | N/A | N/A |
| **Bank** | | | | | | | | |
| **As of December 31, 2016** | | | | | | | | |
| Common equity tier 1 capital ratio | **$ 90,660** | **15.60%** | **$ 26,160** | **≥4.5%** | **$ 29,793** | **≥5.125%** | **$ 37,786** | **≥6.5%** |
| Tier 1 captial ratio | **90,660** | **15.60** | **34,880** | **≥6.0%** | **38,513** | **≥6.625%** | **46,506** | **≥8.0%** |
| Total capital ratio | **97,934** | **16.85** | **46,506** | **≥8.0%** | **50,139** | **≥8.625%** | **58,132** | **≥10.0%** |
| Tier 1 leverage ratio | **90,660** | **9.94** | **36,456** | **≥4.0%** | **N/A** | **N/A** | **45,581** | **≥5.0%** |
| As of December 31, 2015 | | | | | | | | |
| Common equity tier 1 capital ratio | $ 90,133 | 18.17% | $ 22,326 | ≥4.5% | N/A | N/A | $ 32,188 | ≥6.5% |
| Tier 1 captial ratio | 90,133 | 18.17 | 29,768 | ≥6.0% | N/A | N/A | 39,616 | ≥8.0% |
| Total capital ratio | 96,348 | 19.42 | 39,690 | ≥8.0% | N/A | N/A | 49,520 | ≥10.0% |
| Tier 1 leverage ratio | 90,133 | 11.33 | 31,815 | ≥4.0% | N/A | N/A | 39,769 | ≥5.0% |

**Note 11. Financial Instruments with Off-Balance Sheet Risk**

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing need of its customers. These financial instruments consist primarily of commitments to extend credit (typically mortgages and commercial loans) and, to a lesser extent, standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the consolidated statement of condition.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligation as it does for on balance sheet instruments. The Bank does not anticipate any material losses from these commitments.

Commitments to extend credit, including commitments to grant loans and unfunded commitments under lines of credit, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extensions of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, property and equipment and income-producing commercial properties. On loans secured by real estate, the Bank generally requires loan to value ratios of no greater than 80%.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements and similar transactions. The terms of the letters of credit vary and may have renewal features. The credit risk involved in using letters of credit is essentially the same as that involved in extending loans to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees.

The Bank has not been required to perform on any financial guarantees, and has not incurred any losses on its commitments, during the past two years.

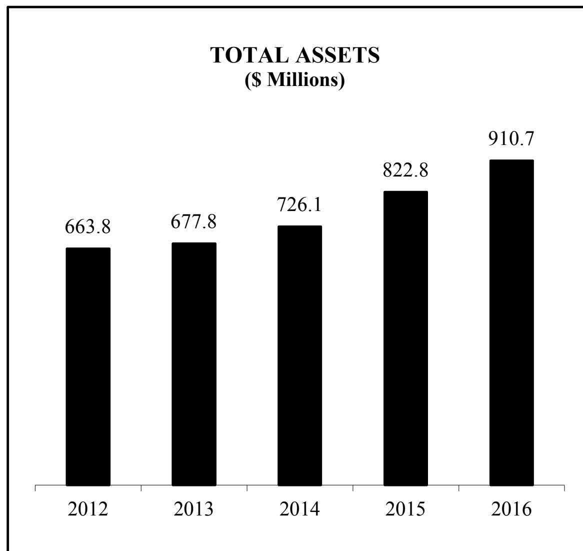
A summary of the Bank's Commitments at December 31, 2016 and 2015 were as follows (in thousands):

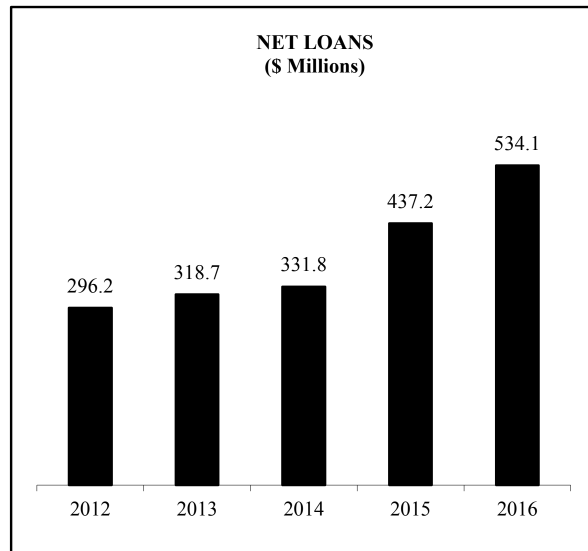
| | **2016** | 2015 |
|---|---|---|
| Commitments to extend credit | **$ 144,519** | $ 115,245 |
| Standby letters of credit | **4,377** | 4,039 |

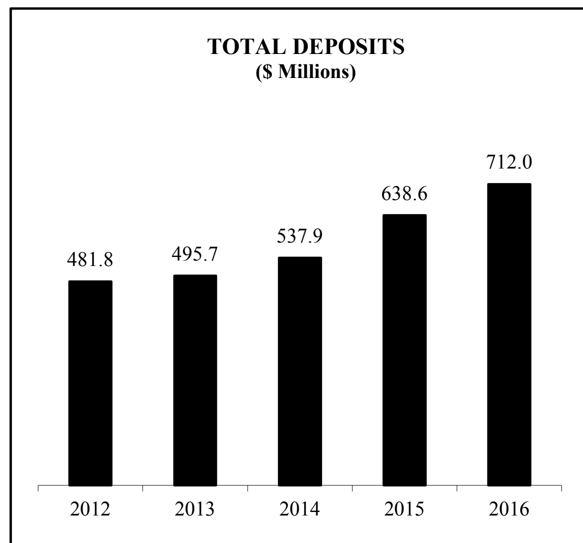
The reserve for unfunded commitments was $594,000 and $144,000 at December 31, 2016 and 2015, respectively. The provision for unfunded commitment losses, which is included in other operating expenses was $450,000 and $64,000 for the years ending December 31, 2016 and 2015, respectively.

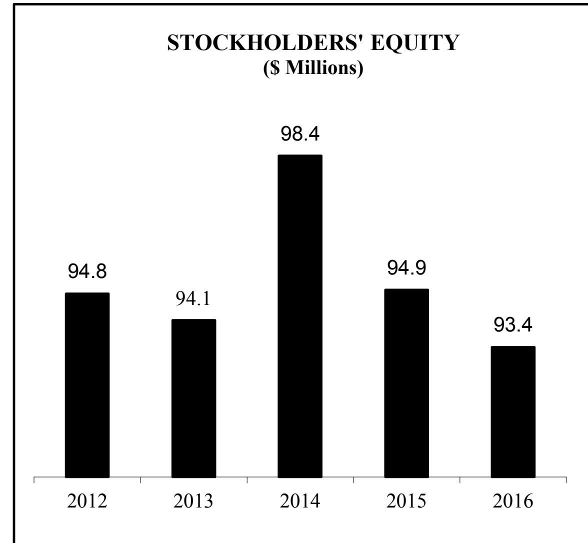
**Note 12. Contigencies**

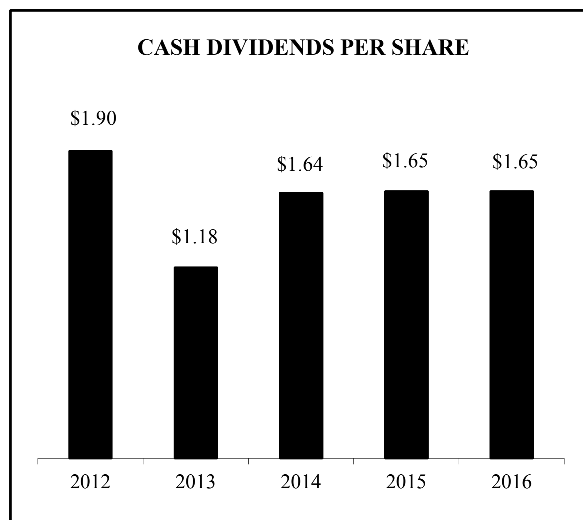
The Company is subject to claims and lawsuits which arise primarily in the ordinary course of business. Based on information presently available and advice received from legal counsel representing the Company in connection with any such claims and lawsuits, it is the opinion of managment that the disposition or ultimate determination of any such claims and lawsuits will not have a material effect on the consolidated financial position, consolidated results or liquidity of the Company.

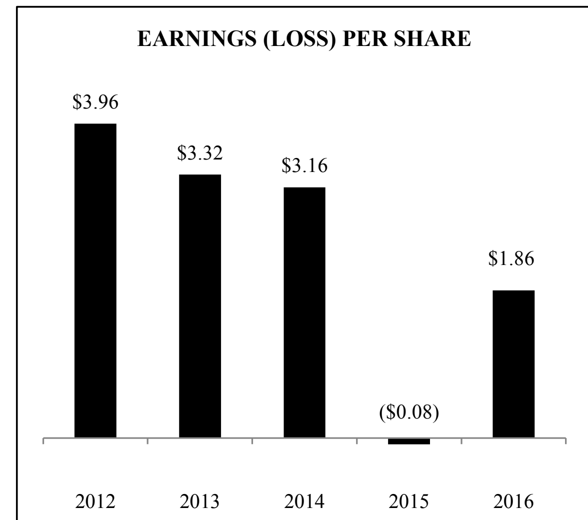

TOTAL ASSETS
($ Millions)
663.8
677.8
726.1
822.8
910.7
2012
2013
2014
2015
2016


NET LOANS
($ Millions)
296.2
318.7
331.8
437.2
534.1
2012
2013
2014
2015
2016


TOTAL DEPOSITS
($ Millions)
481.8
495.7
537.9
638.6
712.0
2012
2013
2014
2015
2016


STOCKHOLDERS' EQUITY
($ Millions)
94.8
94.1
98.4
94.9
93.4
2012
2013
2014
2015
2016


CASH DIVIDENDS PER SHARE
$1.90
$1.18
$1.64
$1.65
$1.65
2012
2013
2014
2015
2016


EARNINGS (LOSS) PER SHARE
$3.96
$3.32
$3.16
($0.08)
$1.86
2012
2013
2014
2015
2016

ORANGE COUNTY BANCORP, INC.
AND ORANGE BANK & TRUST COMPANY

# Board of Directors

Louis Heimbach, Chairman
David A. DeWilde
Michael Gilfeather
Paul T. McDermott
William D. Morrison
Susan Metzger
Virginia Rizzo
Richard Rowley
Terry R. Saturno

Washington Hall,
U.S. Military Academy
in West Point, NY

## OFFICERS – ORANGE COUNTY BANCORP, INC.

**Michael J. Gilfeather, President & CEO**

**Gerard Perri, Senior Vice President, CFO**

**Timothy McCausland, Senior Vice President, CAO**

## ORANGE BANK & TRUST COMPANY OFFICERS

| | |
|---|---|
| Michael J. Gilfeather | President & CEO |
| Gerard Perri | Senior Vice President, CFO |
| Timothy McCausland | Senior Vice President, CAO, Corporate Secretary |
| Christopher Hayden | Senior Vice President, COO |
| Mary Ellen Rogulski | Senior Vice President, CLO |
| Joseph Ruhl | Regional President Westchester County |
| John Bartolotta | Regional President Rockland County |
| Greg Sousa | 1st Vice President, Senior Relationship Manager |
| Pamela A. Jones | 1st Vice President, Human Resource Officer |
| Jayne Rzeczkowski | 1st Vice President, Compliance Officer, Assistant Corporate Secretary |
| Linda LeMond | 1st Vice President, Cash Management & Treasury Officer |
| Elizabeth Jones | 1st Vice President, Director of Branch & Deposit Operations |
| Roland Newkirk | 1st Vice President, Senior Credit Officer |
| Marjorie Buckley | Vice President, Branch Administrator |
| Kim Griffith | Vice President, Relationship Manager, White Plains |
| Michael DiSalvo | Vice President, Commercial Loan Officer |
| John Fracasse | Vice President, Branch Manager & Municipal Development Specialist |
| Marianne Rickers | Vice President, Process Improvement |
| Diane Passaro | Vice President, Commercial Loan Officer |
| Edwin Estrada | Vice President, Commercial Loan Officer |
| David Garlinghouse | Vice President, Commercial Loan Officer |
| Kathy Pinto | Vice President, Information Technology Officer |
| Tracy Stein | Vice President, Controller |
| Patience Calderon | Vice President, Loan Operations Officer |
| Debra Weaver | Vice President, Branch Manager |
| Rose Silvestro | Vice President, Relationship Manager, Mamaroneck |
| Patrick Smith | Vice President, Relationship Manager, Mount Vernon |
| Sharon Spina | Vice President, Relationship Manager, Mount Pleasant |
| Michael Golio | Vice President, Relationship Manager, Mount Pleasant |
| Kathleen Cole | Vice President, Branch Manager |
| Stephen McBride | Vice President, Finance and Business Analyst |
| Carla Alfieri | Assistant Vice President, Training and Development Officer |
| Kathy Bauer | Assistant Vice President, Branch Manager |
| Gina Stellato | Assistant Vice President, Commercial Loan Officer |
| Heather Tancredi | Assistant Vice President, Branch Manager |
| Jennifer Meyer | Assistant Vice President, Branch Manager |
| Denise Panebianco | Assistant Vice President, Human Resource Manager |
| John Nardi | Assistant Vice President, Senior Credit Analyst |
| Anthony Russo | Assistant Vice President, Credit Analyst II |
| Barbara Carr | Assistant Vice President, Mortgage Officer |
| Bob Nowakowsky | Assistant Vice President, CRE Loan Review Analyst |
| Ralph Capellan | Assistant Secretary, Branch Manager |
| Haydee Furman | Assistant Secretary, Branch Manager |
| Lynn Predmore | Assistant Secretary, Assistant Branch Manager |
| Candice Varetoni | Assistant Secretary, Marketing Officer |
| Holly Budd | Assistant Secretary, Deposit Operations Manager |
| Alana Moissett | BSA/OFAC & Financial Privacy Officer |
| Lisa Spizuco | Assistant Secretary, Branch Manager |
| Renee Cece | Assistant Secretary, Loan Operations Administrator/Paralegal |
| Cassandra Paupst | Assistant Secretary, Credit Analyst |

## TRUST DEPARTMENT

| | |
|---|---|
| Kathryn M. Maloney | Senior Vice President Trust Services Director |
| Glenn G. Wassermann | Senior Vice President, Senior Trust Officer |
| Sinead Fitzsimons | Vice President, Senior Trust Officer, Westchester |
| Eileen Osterby | Vice President, Trust Officer |
| Andrea Pecorale | Trust Operations Officer |
| Ana Gomez | Assistant Secretary, Trust Officer |
| Hilda Cabrera | Assistant Secretary, Trust Administrator |

## HUDSON VALLEY INVESTMENT ADVISORS, INC.

# Board of Directors

Lou Heimbach, Chairman

Michael Gilfeather

Thomas Guarino

Peter Larkin

Michael Markhoff

Jonathan Rouis

## HUDSON VALLEY INVESTMENT ADVISORS, INC. OFFICERS

| | |
|---|---|
| Gus Scacco | CEO/Chief Investment Officer |
| Michael Rundle | Vice President, Portfolio Manager |
| Thomas McGimpsey | Vice President, Portfolio Manager |
| Sherri Danny | Vice President, Relationship Manager |
| Mark Lazarczyk | COO, Chief Compliance Officer |
| Melissa Mineau | Vice President, Relationship Manager |
| Timothy McCausland | Corporate Secretary |

# Locations

## MIDDLETOWN
212 DOLSON AVENUE
MIDDLETOWN, NY 10940
T. 845-341-5000

33 TRUST WAY
MIDDLETOWN , NY 10940
T. 845-341-5074

75 NORTH STREET
MIDDLETOWN , NY 10940
T. 845-341-5013

## MONTGOMERY
2093 STATE ROUTE 208
MONTGOMERY, NY 12549
T. 845-457-9020

## VAILS GATE
BIG V TOWN CENTRE
376 WINDSOR HWY (RT 32)
VAILS GATE, NY 12584
T. 845-568-5501

## CHESTER
91 BROOKSIDE AVENUE
CHESTER, NY 10918
T. 845-469-6282

## GOSHEN
146 NORTH CHURCH STREET
GOSHEN, NY 10924
T. 845-294-9700

## NEWBURGH
78 NORTH PLANK ROAD
NEWBURGH, NY 12550
T. 845-561-5004

## FISHKILL
701 ROUTE 9
FISHKILL, NY 12524
T. 845-202-5600

## WHITE PLAINS
42 WALLER AVENUE
WHITE PLAINS, NY 10601
T. 914-422-3100

## NEW CITY
49 MAPLE AVENUE
NEW CITY, NY 10956
T. 845-639-1000

## MAMARONECK
1214 EAST BOSTON POST ROAD
MAMARONECK, NY 10543
T. 914-341-7130

## MT. PLEASANT
7 WEST CROSS STREET
2ND FLOOR, SUITE 7A
HAWTHORNE, NY 10532
T. 914-984-2780

UPPER
PARK

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