HEICO CORP
Form 10-Q
August 27, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended July 31, 2015

OR

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

For the transition period from ______ to _______

Commission File Number: 1-4604

HEICO CORPORATION
(Exact name of registrant as specified in its charter)

Florida	65-0341002
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3000 Taft Street, Hollywood, Florida	33021
(Address of principal executive offices)	(Zip Code)

(954) 987-4000
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

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

The number of shares outstanding of each of the registrant's classes of common stock as of August 26, 2015 is as follows:

Common Stock, $.01 par value	26,898,938	shares
Class A Common Stock, $.01 par value	39,935,811	shares

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HEICO CORPORATION

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PART I. FINANCIAL INFORMATION; Item 1. FINANCIAL STATEMENTS

HEICO CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS - UNAUDITED
(in thousands, except per share data)

	July 31, 2015	October 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$31,697	$20,229
Accounts receivable, net	150,930	149,669
Inventories, net	236,235	218,042
Prepaid expenses and other current assets	9,850	8,868
Deferred income taxes	34,150	34,485
Total current assets	462,862	431,293
Property, plant and equipment, net	103,175	93,865
Goodwill	713,127	686,271
Intangible assets, net	220,514	200,810
Deferred income taxes	974	1,063
Other assets	87,762	75,912
Total assets	$1,588,414	$1,489,214
LIABILITIES AND EQUITY		
Current liabilities:		
Current maturities of long-term debt	$343	$418
Trade accounts payable	53,035	57,157
Accrued expenses and other current liabilities	91,390	92,578
Income taxes payable	2,062	2,067
Total current liabilities	146,830	152,220
Long-term debt, net of current maturities	299,126	328,691
Deferred income taxes	114,618	111,429
Other long-term liabilities	106,437	82,289
Total liabilities	667,011	674,629
Commitments and contingencies (Note 10)		
Redeemable noncontrolling interests (Note 3)	64,821	39,966
Shareholders’ equity:		
Common Stock, $.01 par value per share; 75,000 shares authorized; 26,899 and 26,847 shares issued and outstanding	269	268
Class A Common Stock, $.01 par value per share; 75,000 shares authorized; 39,936 and 39,699 shares issued and outstanding	399	397
Capital in excess of par value	283,490	269,351
Deferred compensation obligation	1,296	1,138
HEICO stock held by irrevocable trust	(1,296)	(1,138)
Accumulated other comprehensive loss	(24,562)	(8,289)
Retained earnings	516,007	437,757

Total HEICO shareholders’ equity	775,603	699,484
Noncontrolling interests	80,979	75,135
Total shareholders’ equity	856,582	774,619
Total liabilities and equity	$1,588,414	$1,489,214

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

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HEICO CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS – UNAUDITED
(in thousands, except per share data)

	Nine months ended July 31,		Three months ended July 31,	
	2015	2014	2015	2014
Net sales	$859,976	$840,088	$300,370	$291,030
Operating costs and expenses:				
Cost of sales	552,593	544,722	192,278	187,703
Selling, general and administrative expenses	146,679	145,697	49,582	53,214
Total operating costs and expenses	699,272	690,419	241,860	240,917
Operating income	160,704	149,669	58,510	50,113
Interest expense	(3,346)	(4,166)	(1,088)	(1,444)
Other income (expense)	375	591	(184)	83
Income before income taxes and noncontrolling interests	157,733	146,094	57,238	48,752
Income tax expense	48,200	43,400	18,300	11,400
Net income from consolidated operations	109,533	102,694	38,938	37,352
Less: Net income attributable to noncontrolling interests	14,419	13,506	4,569	3,986
Net income attributable to HEICO	$95,114	$89,188	$34,369	$33,366
Net income per share attributable to HEICO shareholders:				
Basic	$1.43	$1.34	$.51	$.50
Diluted	$1.40	$1.32	$.51	$.49
Weighted average number of common shares outstanding:				
Basic	66,706	66,442	66,813	66,497
Diluted	67,790	67,427	67,901	67,474
Cash dividends per share	$.14	$.47	$.07	$.06

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

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HEICO CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF
COMPREHENSIVE INCOME – UNAUDITED
(in thousands)

	Nine months ended July 31,		Three months ended July 31,	
	2015	2014	2015	2014
Net income from consolidated operations	$109,533	$102,694	$38,938	$37,352
Other comprehensive loss:				
Foreign currency translation adjustments	(17,177)	(2,715)	(5,442)	(2,064)
Total other comprehensive loss	(17,177)	(2,715)	(5,442)	(2,064)
Comprehensive income from consolidated operations	92,356	99,979	33,496	35,288
Less: Net income attributable to noncontrolling interests	14,419	13,506	4,569	3,986
Less: Foreign currency translation adjustments attributable to noncontrolling interests	(904)	—	(94)	—
Comprehensive income attributable to noncontrolling interests	13,515	13,506	4,475	3,986
Comprehensive income attributable to HEICO	$78,841	$86,473	$29,021	$31,302

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HEICO CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS’ EQUITY - UNAUDITED
(in thousands, except per share data)

		HEICO Shareholders' Equity								
	Redeemable Noncontrolling Interests	Common Stock	Class A Common Stock	Capital in Excess of Par Value	Deferred Compensation Obligation	HEICO Stock Held by Irrevocable Trust	Accumulated Other Comprehensive Loss	Retained Earnings	Noncontrolling Interests	Total Shareholders' Equity
Balances as of October 31, 2014	$39,966	$268	$397	$269,351	$1,138	($1,138)	($8,289)	$437,757	$75,135	$774,619
Comprehensive income (loss)	3,880	—	—	—	—	—	(16,273)	95,114	9,635	88,476
Cash dividends ($.14 per share)	—	—	—	—	—	—	—	(9,343)	—	(9,343)
Issuance of common stock to HEICO Savings and Investment Plan	—	1	—	5,090	—	—	—	—	—	5,091
Share-based compensation expense	—	—	—	4,394	—	—	—	—	—	4,394
Proceeds from stock option exercises	—	—	2	3,256	—	—	—	—	—	3,258
Tax benefit from stock option exercises	—	—	—	1,404	—	—	—	—	—	1,404
Redemptions of common stock related to share-based compensation	—	—	—	(5)	—	—	—	—	—	(5)
Noncontrolling interests assumed related to acquisitions	17,076	—	—	—	—	—	—	—	—	—
Distributions to noncontrolling interests	(3,623)	—	—	—	—	—	—	—	(3,791)	(3,791)
Adjustments to redemption amount of redeemable noncontrolling interests	7,522	—	—	—	—	—	—	(7,522)	—	(7,522)
	—	—	—	—	158	(158)	—	—	—	—

Deferred compensation obligation										
Other	—	—	—	—	—	—	—	1	—	1
Balances as of July 31, 2015	$64,821	$269	$399	$283,490	$1,296	($1,296)	($24,562)	$516,007	$80,979	$856,582

		HEICO Shareholders' Equity								
	Redeemable Noncontrolling Interests	Common Stock	Class A Common Stock	Capital in Excess of Par Value	Deferred Compensation Obligation	HEICO Stock Held by Irrevocable Trust	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Noncontrolling Interests	Total Shareholders' Equity
Balances as of October 31, 2013	$59,218	$268	$396	$255,889	$1,138	($1,138)	$144	$349,649	$116,889	$723,235
Comprehensive income (loss)	4,180	—	—	—	—	—	(2,715)	89,188	9,326	95,799
Cash dividends ($.47 per share)	—	—	—	—	—	—	—	(31,215)	—	(31,215)
Issuance of common stock to HEICO Savings and Investment Plan	—	—	—	3,849	—	—	—	—	—	3,849
Share-based compensation expense	—	—	1	5,873	—	—	—	—	—	5,874
Proceeds from stock option exercises	—	—	—	594	—	—	—	—	—	594
Tax benefit from stock option exercises	—	—	—	93	—	—	—	—	—	93
Redemptions of common stock related to share-based compensation	—	—	—	(273)	—	—	—	—	—	(273)
Distributions to noncontrolling interests	(4,141)	—	—	—	—	—	—	—	(72,576)	(72,576)
Acquisitions of noncontrolling interests	(1,243)	—	—	—	—	—	—	—	—	—
Reclassification of redeemable noncontrolling interests to noncontrolling interests	(19,383)	—	—	—	—	—	—	—	19,383	19,383
	(526)	—	—	—	—	—	—	526	—	526

Adjustments to redemption amount of redeemable noncontrolling interests										
Other	—	—	—	4	—	—	—	—	1	5
Balances as of July 31, 2014	$38,105	$268	$397	$266,029	$1,138	($1,138)	($2,571)	$408,148	$73,023	$745,294

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

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HEICO CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - UNAUDITED
(in thousands)

	Nine months ended July 31,	
	2015	2014
Operating Activities:		
Net income from consolidated operations	$109,533	$102,694
Adjustments to reconcile net income from consolidated operations to net cash provided by operating activities:		
Depreciation and amortization	35,066	36,270
Impairment of intangible assets	—	9,200
Share-based compensation expense	4,394	5,874
Employer contributions to HEICO Savings and Investment Plan	4,482	3,849
Deferred income tax benefit	(4,909)	(11,549)
Tax benefit from stock option exercises	1,404	93
Excess tax benefit from stock option exercises	(1,404)	(93)
Decrease in accrued contingent consideration, net	(412)	(19,516)
Foreign currency transaction adjustments, net	(3,981)	—
Changes in operating assets and liabilities, net of acquisitions:		
Decrease in accounts receivable	4,482	7,909
Increase in inventories	(10,653)	(2,289)
(Increase) decrease in prepaid expenses and other current assets	(548)	7,048
Decrease in trade accounts payable	(6,570)	(6,129)
Decrease in accrued expenses and other current liabilities	(7,977)	(12,456)
(Decrease) increase in income taxes payable	(401)	420
Other long-term assets and liabilities, net	(1,217)	5,908
Net cash provided by operating activities	121,289	127,233
Investing Activities:		
Acquisitions, net of cash acquired	(56,198)	(8,737)
Capital expenditures	(13,767)	(12,261)
Other	171	(30)
Net cash used in investing activities	(69,794)	(21,028)
Financing Activities:		
Borrowings on revolving credit facility	68,696	112,000
Payments on revolving credit facility	(95,000)	(102,000)
Distributions to noncontrolling interests	(7,414)	(76,717)
Cash dividends paid	(9,343)	(31,215)
Acquisitions of noncontrolling interests	—	(1,243)
Revolving credit facility issuance costs	—	(767)
Redemptions of common stock related to share-based compensation	(5)	(273)
Proceeds from stock option exercises	3,258	594
Excess tax benefit from stock option exercises	1,404	93
Other	(290)	(1,082)
Net cash used in financing activities	(38,694)	(100,610)
Effect of exchange rate changes on cash	(1,333)	(150)
Net increase in cash and cash equivalents	11,468	5,445

Cash and cash equivalents at beginning of year	20,229	15,499
Cash and cash equivalents at end of period	$31,697	$20,944

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

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HEICO CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – UNAUDITED

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of HEICO Corporation and its subsidiaries (collectively, "HEICO," or the "Company") have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and in accordance with the instructions to Form 10-Q. Therefore, the condensed consolidated financial statements do not include all information and footnotes normally included in annual consolidated financial statements and should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended October 31, 2014. The October 31, 2014 Condensed Consolidated Balance Sheet has been derived from the Company's audited consolidated financial statements. In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments (consisting principally of normal recurring accruals) necessary for a fair presentation of the condensed consolidated balance sheets, statements of operations, statements of comprehensive income, statements of shareholders' equity and statements of cash flows for such interim periods presented. The results of operations for the nine months ended July 31, 2015 are not necessarily indicative of the results which may be expected for the entire fiscal year.

The Company has two operating segments: the Flight Support Group ("FSG"), consisting of HEICO Aerospace Holdings Corp. ("HEICO Aerospace") and HEICO Flight Support Corp. and their collective subsidiaries; and the Electronic Technologies Group ("ETG"), consisting of HEICO Electronic Technologies Corp. ("HEICO Electronic") and its subsidiaries.

New Accounting Pronouncements

In March 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-05, "Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity," which clarifies the applicable guidance for the release of any cumulative translation adjustments into net earnings. ASU 2013-05 specifies that the entire amount of cumulative translation adjustments should be released into earnings when an entity ceases to have a controlling financial interest in a subsidiary or group of assets within a consolidated foreign entity and the sale or transfer results in the complete or substantially complete liquidation of the investment in the foreign entity. The Company adopted ASU 2013-05 in the first quarter of fiscal 2015, resulting in no impact on the Company's consolidated results of operations, financial position or cash flows.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers," which provides a comprehensive new revenue recognition model that will supersede

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nearly all existing revenue recognition guidance. Under ASU 2014-09, an entity will recognize revenue when it transfers promised goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. The guidance also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts. In August 2015, the FASB issued ASU 2015-14 which defers the effective date of ASU 2014-09 by one year. Accordingly, ASU 2014-09 is effective for fiscal years and interim reporting periods within those years beginning after December 15, 2017, or in fiscal 2019 for HEICO. Early adoption is not permitted. ASU 2014-09 shall be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application. The Company is currently evaluating which transition method it will elect and the effect the adoption of this guidance will have on its consolidated results of operations, financial position and cash flows.

In July 2015, the FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory,” which requires entities to measure inventories at the lower of cost or net realizable value. Under current guidance, inventories are measured at the lower of cost or market. ASU 2015-11 must be applied prospectively and is effective for fiscal years and interim reporting periods within those years beginning after December 15, 2016, or in fiscal 2018 for HEICO. Early adoption is permitted. The Company is currently evaluating the effect, if any, the adoption of this guidance will have on its consolidated results of operations, financial position and cash flows.

2. ACQUISITIONS

In January 2015, the Company, through its HEICO Flight Support Corp. subsidiary, acquired 80% of the equity of Aeroworks International Holdings, B.V. (“Aeroworks”). Aeroworks, which is headquartered in The Netherlands and maintains a significant portion of its production facilities in Thailand and Laos, is a manufacturer of both composite and metal parts used primarily in aircraft interior applications, including seating, galleys, lavatories, doors, and overhead bins. The remaining 20% interest continues to be owned by a certain member of Aeroworks' management team (see Note 3, Selected Financial Statement Information, for additional information). The total consideration includes an accrual representing the estimated fair value of contingent consideration that the Company may be obligated to pay should Aeroworks meet certain earnings objectives during each of the first four years following the acquisition. See Note 7, Fair Value Measurements, for additional information regarding the Company’s contingent consideration obligation.

In January 2015, the Company, through its HEICO Flight Support Corp. subsidiary, acquired 80.1% of the equity of Harter Aerospace, LLC ("Harter"). Harter is a globally recognized component and accessory maintenance, repair, and overhaul (MRO) station specializing in commercial aircraft accessories, including thrust reverse actuation systems and pneumatics, and electromechanical components. The remaining 19.9% interest continues to be

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owned by certain members of Harter's management team (see Note 3, Selected Financial Statement Information, for additional information).

In May 2015, the Company, through its HEICO Flight Support Corp. subsidiary, acquired all of the stock of Thermal Energy Products, Inc. (“TEP”). TEP engineers, designs and manufactures removable/reusable insulation systems for industrial, commercial, aerospace and defense applications.

The purchase prices of the fiscal 2015 acquisitions were paid in cash principally using proceeds from the Company’s revolving credit facility and the total consideration for the acquisitions is not material or significant to the Company's condensed consolidated financial statements. The allocation of the total consideration to the tangible and identifiable intangible assets acquired and liabilities and noncontrolling interests assumed for the fiscal 2015 acquisitions is preliminary until the Company obtains final information regarding their fair values.

The operating results of the fiscal 2015 acquisitions were included in the Company’s results of operations from the effective acquisition dates. The amount of net sales and earnings of the fiscal 2015 acquisitions included in the Condensed Consolidated Statements of Operations is not material. Had the fiscal 2015 acquisitions been consummated as of November 1, 2013, net sales, net income from consolidated operations, net income attributable to HEICO, and basic and diluted net income per share attributable to HEICO shareholders on a pro forma basis for the nine and three months ended July 31, 2015 and July 31, 2014 would not have been materially different than the reported amounts.

3. SELECTED FINANCIAL STATEMENT INFORMATION

Accounts Receivable

(in thousands)	July 31, 2015		October 31, 2014	
Accounts receivable	$153,185		$151,812	
Less: Allowance for doubtful accounts	(2,255	)	(2,143	)
Accounts receivable, net	$150,930		$149,669	

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Costs and Estimated Earnings on Uncompleted Percentage-of-Completion Contracts

(in thousands)	July 31, 2015	October 31, 2014
Costs incurred on uncompleted contracts	$22,814	$24,437
Estimated earnings	11,761	11,747
	34,575	36,184
Less: Billings to date	(35,284)	(29,829)
	($709)	$6,355
Included in the accompanying Condensed Consolidated Balance Sheets under the following captions:		
Accounts receivable, net (costs and estimated earnings in excess of billings)	$4,695	$8,161
Accrued expenses and other current liabilities (billings in excess of costs and estimated earnings)	(5,404)	(1,806)
	($709)	$6,355

Changes in estimates pertaining to percentage-of-completion contracts did not have a material effect on net income from consolidated operations for the nine and three months ended July 31, 2015 and 2014.

Inventories

(in thousands)	July 31, 2015	October 31, 2014
Finished products	$113,626	$106,229
Work in process	32,871	30,056
Materials, parts, assemblies and supplies	87,598	79,163
Contracts in process	4,508	2,594
Less: Billings to date	(2,368)	—
Inventories, net of valuation reserves	$236,235	$218,042

Contracts in process represents accumulated capitalized costs associated with fixed price contracts. Related progress billings and customer advances (“billings to date”) are classified as a reduction to contracts in process, if any, and any excess is included in accrued expenses and other liabilities.

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Property, Plant and Equipment

(in thousands)	July 31, 2015	October 31, 2014
Land	$4,954	$4,501
Buildings and improvements	69,091	60,332
Machinery, equipment and tooling	152,249	139,963
Construction in progress	6,630	6,905
	232,924	211,701
Less: Accumulated depreciation and amortization	(129,749)	(117,836)
Property, plant and equipment, net	$103,175	$93,865

Accrued Customer Rebates and Credits

The aggregate amount of accrued customer rebates and credits included within accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets was $7.8 million and $10.9 million as of July 31, 2015 and October 31, 2014, respectively. The total customer rebates and credits deducted within net sales for the nine months ended July 31, 2015 and 2014 was $4.3 million and $5.3 million, respectively. The total customer rebates and credits deducted within net sales for the three months ended July 31, 2015 and 2014 was $1.4 million and $1.9 million, respectively. The decrease in the amount of accrued customer rebates and credits since October 31, 2014 principally reflects payments made during fiscal 2015.

Employee Retirement Plan

The components of net pension income for the nine and three months ended July 31, 2015 and 2014 that were recorded within the Company's Condensed Consolidated Statements of Operations are as follows (in thousands):

	Nine months ended July 31,		Three months ended July 31,	
	2015	2014	2015	2014
Expected return on plan assets	$555	$555	$185	$185
Interest cost	420	459	140	153
Net pension income	$135	$96	$45	$32

Research and Development Expenses

The amount of new product research and development ("R&D") expenses included in cost of sales for the nine and three months ended July 31, 2015 and 2014 is as follows (in thousands):

	Nine months ended July 31,		Three months ended July 31,	
	2015	2014	2015	2014
R&D expenses	$28,860	$28,278	$9,421	$9,862

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Redeemable Noncontrolling Interests

The holders of equity interests in certain of the Company's subsidiaries have put rights that may be exercised on varying dates causing the Company to give cash consideration to purchase their equity interests based on fair value or a formula that management intended to reasonably approximate fair value based solely on a multiple of future earnings over a measurement period. Management's estimate of the aggregate redemption amount of all put rights (inclusive of the fiscal 2015 transactions described below) that the Company could be required to pay at varying dates through fiscal 2023 is as follows (in thousands):

	July 31, 2015	October 31, 2014
Redeemable at fair value	$52,521	$27,666
Redeemable based on a multiple of future earnings	12,300	12,300
Redeemable noncontrolling interests	$64,821	$39,966

As discussed in Note 2, Acquisitions, the Company, through the FSG, acquired interests of 80% and 80.1% in Aeroworks and Harter, respectively, in January 2015. As part of the Aeroworks purchase agreement, the Company has the right to purchase the noncontrolling interest over a four-year period beginning in fiscal 2019, or sooner under certain conditions, and the noncontrolling interest holder has the right to cause the Company to purchase the same equity interest over the same period. As part of the Harter purchase agreement, the Company has the right to purchase the noncontrolling interests over a four-year period beginning in fiscal 2020, or sooner under certain conditions, and the noncontrolling interest holders have the right to cause the Company to purchase the same equity interests over the same period.

Accumulated Other Comprehensive Loss

Changes in the components of accumulated other comprehensive loss for the nine months ended July 31, 2015 are as follows (in thousands):

	Foreign Currency Translation	Pension Benefit Obligation	Accumulated Other Comprehensive Loss
Balances as of October 31, 2014	($8,348)	$59	($8,289)
Unrealized loss	(16,273)	—	(16,273)
Balances as of July 31, 2015	($24,621)	$59	($24,562)

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4. GOODWILL AND OTHER INTANGIBLE ASSETS

Changes in the carrying amount of goodwill by operating segment for the nine months ended July 31, 2015 are as follows (in thousands):

	Segment FSG	ETG	Consolidated Totals
Balances as of October 31, 2014	$282,407	$403,864	$686,271
Goodwill acquired	36,064	—	36,064
Foreign currency translation adjustments	(1,704)	(7,504)	(9,208)
Balances as of July 31, 2015	$316,767	$396,360	$713,127

The goodwill acquired pertains to the fiscal 2015 acquisitions described in Note 2, Acquisitions, and represents the residual value after the allocation of the total consideration to the tangible and identifiable intangible assets acquired and liabilities and noncontrolling interests assumed. The Company estimates that approximately $7 million of the goodwill acquired in fiscal 2015 will be deductible for income tax purposes.

Identifiable intangible assets consist of the following (in thousands):

	As of July 31, 2015			As of October 31, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizing Assets:						
Customer relationships	$156,119	($60,058)	$96,061	$144,478	($55,393)	$89,085
Intellectual property	83,760	(20,932)	62,828	73,005	(17,620)	55,385
Licenses	2,900	(1,810)	1,090	2,900	(1,645)	1,255
Non-compete agreements	915	(915)	—	1,020	(1,020)	—
Patents	731	(432)	299	712	(405)	307
Trade names	166	(33)	133	166	(17)	149
	244,591	(84,180)	160,411	222,281	(76,100)	146,181
Non-Amortizing Assets:						
Trade names	60,103	—	60,103	54,629	—	54,629
	$304,694	($84,180)	$220,514	$276,910	($76,100)	$200,810

The increase in the gross carrying amount of customer relationships, intellectual property and non-amortizing trade names as of July 31, 2015 compared to October 31, 2014 principally relates to such intangible assets recognized in connection with the fiscal 2015 acquisitions (see Note 2, Acquisitions). The weighted-average amortization period of the customer relationships and intellectual property acquired during fiscal 2015 is 10 and 12 years, respectively.

Amortization expense related to intangible assets for the nine months ended July 31, 2015 and 2014 was $19.7 million and $21.1 million, respectively. Amortization expense related to intangible assets for the three months ended July 31, 2015 and 2014 was $6.6 million and $7.0

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million, respectively. Amortization expense related to intangible assets for the remainder of fiscal 2015 is estimated to be $6.5 million. Amortization expense for each of the next five fiscal years and thereafter is estimated to be $25.2 million in fiscal 2016, $24.3 million in fiscal 2017, $22.5 million in fiscal 2018, $20.6 million in fiscal 2019, $18.1 million in fiscal 2020, and $43.2 million thereafter.

5. LONG-TERM DEBT

Long-term debt consists of the following (in thousands):

	July 31, 2015	October 31, 2014
Borrowings under revolving credit facility	$297,046	$326,000
Capital leases	2,423	3,109
	299,469	329,109
Less: Current maturities of long-term debt	(343)	(418)
	$299,126	$328,691

During the first quarter of fiscal 2015, the Company elected to borrow €32 million under its revolving credit facility, which allows for borrowings made in foreign currencies up to a $50 million sublimit. The funds were used to facilitate an acquisition made during the same fiscal quarter. As of July 31, 2015, the United States ("U.S.") dollar equivalent of the Company's Euro borrowing was $35.0 million.

As of July 31, 2015 and October 31, 2014, the weighted average interest rate on borrowings under the Company’s revolving credit facility was 1.3%. The revolving credit facility contains both financial and non-financial covenants. As of July 31, 2015, the Company was in compliance with all such covenants.

6. INCOME TAXES

As of July 31, 2015, the Company’s liability for gross unrecognized tax benefits related to uncertain tax positions was $1.0 million of which $.7 million would decrease the Company’s income tax expense and effective income tax rate if the tax benefits were recognized. A reconciliation of the activity related to the liability for gross unrecognized tax benefits for the nine months ended July 31, 2015 is as follows (in thousands):

Balance as of October 31, 2014	$879
Increases related to current year tax positions	114
Increases related to prior year tax positions	14
Lapse of statute of limitations	(52)
Balance as of July 31, 2015	$955

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There were no material changes in the liability for unrecognized tax positions resulting from tax positions taken during the current or a prior year, settlements with other taxing authorities or a lapse of applicable statutes of limitations. The accrual of interest and penalties related to the unrecognized tax benefits was not material for the nine months ended July 31, 2015. Further, the Company does not expect the total amount of unrecognized tax benefits to materially change in the next twelve months.

The Company’s effective tax rate in the first nine months of fiscal 2015 increased to 30.6% from 29.7% in the first nine months of fiscal 2014. The increase is principally due to the impact of a larger reduction in accrued contingent consideration in the first nine months of fiscal 2014 associated with a prior year acquisition acquired by means of a nontaxable stock transaction. This increase was partially offset by an income tax credit for qualified R&D activities for the last ten months of fiscal 2014 that was recognized in the first quarter of fiscal 2015 resulting from the retroactive extension of the U.S. federal R&D tax credit in December 2014 to cover calendar year 2014 and the benefit of recognizing additional foreign tax credits related to R&D activities at one of the Company's foreign subsidiaries inclusive of a prior year tax return amendment.

The Company’s effective tax rate in the third quarter of fiscal 2015 increased to 32.0% from 23.4% in the third quarter of fiscal 2014. The increase is principally due to the impact of a larger reduction in accrued contingent consideration in the third quarter of fiscal 2014 compared to fiscal 2015 associated with a prior year acquisition acquired by means of a nontaxable stock transaction.

The Company has not made a provision for U.S. income taxes on the undistributed earnings of a fiscal 2015 foreign acquisition as such earnings are considered permanently reinvested outside of the U.S. The amount of undistributed earnings is not material to the Company's condensed consolidated financial statements.

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7. FAIR VALUE MEASUREMENTS

The Company's assets and liabilities that were measured at fair value on a recurring basis are set forth by level within the fair value hierarchy in the following tables (in thousands):

	As of July 31, 2015			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Deferred compensation plans:				
Corporate owned life insurance	$—	$75,809	$—	$75,809
Money market funds	2,482	—	—	2,482
Equity securities	2,131	—	—	2,131
Mutual funds	1,737	—	—	1,737
Other	967	50	—	1,017
Total assets	$7,317	34		

On April 19, 2016, the Board of Directors declared a cash dividend of $0.22 per share to shareholders of record on May 18, 2016, payable on June 1, 2016.

Comparison of the Three Months Ended March 31, 2016

Operations Overview:

Net income for the first quarter of 2016 was $1,292,000, an increase of $368,000, or 39.8%, when compared to the first quarter of 2015. The increase was due primarily to growth of earning assets as a result of the acquisition of FNBPA Bancorp, Inc. ("FNBPA"), consummated on November 30, 2015. Basic and diluted earnings per share were $0.27 in the first quarter of 2016 compared to $0.22 in the first quarter of 2015. Presented below are selected key ratios for the two periods:

	Three Months Ended March 31,			
	2016		2015	
Return on average assets (annualized)	0.88	%	0.78	%
Return on average equity (annualized)	8.50	%	7.36	%
Average equity to average assets	10.39	%	10.54	%
Non-interest income, excluding securities gains, as a percentage of average assets (annualized)	0.81	%	0.85	%
Non-interest expense as a percentage of average assets (annualized)	2.83	%	3.03	%

Excluding tax-effected merger and acquisition costs incurred during the quarter ending March 31, 2016 and 2015, annualized return on average assets and annualized return on average equity were 0.91% and 8.75%, respectively in the 2016 period and 0.78% and 7.44%, respectively, in the 2015 period.

The discussion that follows further explains changes in the components of net income when comparing the first quarter of 2016 with the first quarter of 2015.

Net Interest Income:

Net interest income was $4,629,000 for the first quarter of 2016, as compared to $3,661,000 in the same quarter in 2015. Average earning assets increased by 23.3%, and the net interest margin, on a fully tax equivalent basis, increased by 8 basis points.

Average loan balances increased by $89.4 million, or 30.5%, and interest on loans increased $894,000 in the first quarter of 2016 as compared to the same period in 2015. The acquisition of FNBPA added approximately $47 million in loans, while the remaining amount of the increase, approximately $42 million, was the result of new loan origination. The increase in average loans outstanding increased interest income by $993,000 but was partially offset by a decrease of 20 basis points in the average weighted yield that reduced interest income by approximately $138,000. The difference in the number of days in the comparative quarters resulted in increased interest income of $39,000.

Interest earned on investment securities increased $64,000 in the first quarter of 2016 as compared to the first quarter of 2015. Yield increases added $53,000, while average balance increases added $11,000 to interest income. The overall pre-tax yield on the investment securities portfolio increased during the period by 5 basis points, with the average balance increasing by $9.8 million.

Total average earning assets during the first quarter of 2016 were $536.8 million, compared to $435.4 million during the first quarter of 2015, yielding 3.87% and 3.89%, respectively, in the 2016 and 2015 periods. Average interest-bearing liabilities increased by $69.0 million, while average non-interest bearing deposits increased $27.6 million. Of the increases, the FNBPA acquisition added approximately $57 million and $20 million, to interest-bearing liabilities and non-interest bearing deposits, respectively. The cost to fund interest earning assets dropped by 12 basis points, to 0.55%, in the first quarter of 2016 compared to the first quarter of 2015.

Net interest margin on a fully tax-equivalent basis for the first quarter of 2016 was 3.58%. For the same period in 2015, the fully-tax equivalent net interest margin was 3.50%.

AVERAGE BALANCE SHEETS AND NET INTEREST INCOME ANALYSIS

(Dollars in thousands)

	Three Months Ended March 31, 2016			Three Months Ended March 31, 2015			Increase (Decrease) Due To (6)			
	Average Balance (1)	Interest	Yield/ Rate	Average Balance (1)	Interest	Yield/ Rate	Calendar	Volume	Rate	Total
ASSETS										
Interest earning assets:										
Taxable loans (5)	$347,852	$4,205	4.84 %	$269,050	$3,379	5.03 %	$37	$921	$(132)	$826
Tax-exempt loans	34,526	236	2.74	23,921	168	2.85	2	72	(6)	68
Total loans	382,378	4,441	4.65	292,971	3,547	4.85	39	993	(138)	894
									-	-
Taxable investment securities	125,999	631	2.00	111,554	561	2.01	-	72	(2)	70
Tax-exempt investment securities	26,002	112	1.72	30,631	118	1.54	-	(19)	13	(6)
Total investment securities	152,001	743	1.96	142,185	679	1.91	-	53	11	64
									-	-
Interest bearing deposits	562	1	0.79	162	-	0.06	-	-	1	1
Federal funds sold	1,857	2	0.43	63	-	0.02	-	1	1	2
Total interest earning assets	536,798	5,187	3.87	435,381	4,226	3.89	39	1,047	(125)	961
Other assets (7)	47,956			40,870						
Total assets	$584,754			$476,251						
LIABILITIES AND STOCKHOLDERS' EQUITY										
Interest bearing liabilities:										
Interest bearing demand deposits (2)	$117,114	56	0.19	$93,781	34	0.15	-	10	12	22
Savings deposits	96,697	29	0.12	69,204	17	0.10	-	8	4	12
Time deposits	140,746	355	1.01	137,388	430	1.27	5	10	(90)	(75)
Other, including short-term borrowings, long-term debt and other	56,929	118	0.83	42,110	84	0.80	1	30	3	34

interest bearing liabilities										
Total interest bearing liabilities	411,486	558	0.55	342,483	565	0.67	6	58	(71)	(7)
Non-interest bearing liabilities:										
Demand deposits	106,130			78,507						
Other	6,369			5,061						
Stockholders' equity	60,769			50,200						
Total liabilities and stockholders' equity	$584,754			$476,251						
Net interest income and net interest rate spread		$4,629	3.32 %		$3,661	3.22 %	$33	$989	$(54)	$968
Net interest margin on interest earning assets (3)			3.45 %			3.36 %				
Net interest income and net interest margin-Tax equivalent basis (4)		$4,808	3.58 %		$3,808	3.50 %				

Notes:

1) Average balances were calculated using a daily average.

2) Includes interest-bearing demand and money market accounts.

3) Net margin on interest earning assets is net interest income divided by average interest earning assets.

4) Interest on obligations of states and municipalities is not subject to federal income tax. In order to make the net yield comparable on a fully taxable basis, a tax equivalent adjustment is applied against the tax-exempt income utilizing a federal tax rate of 34%.

5) Non-accruing loans are included in the above table until they are charged off.

6) The change in interest due to rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

(7) Includes gross unrealized gains (losses) on securities available for sale.

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Provision for Loan Losses:

In the first quarter of 2016, the provision for loan losses was $121,000, as compared to a provision of $50,000 in the first quarter of 2015. Management regularly reviews the adequacy of the loan loss reserve and makes assessments as to specific loan impairment, historical charge-off expectations, general economic conditions in the Bank's market area, specific loan quality and other factors. Factors affecting the provision for loan losses were the increased loan balances considered in the analysis and credit concentrations. See the earlier discussion in the Financial Condition section, explaining the information used to determine the provision.

Non-interest Income:

Non-interest income in the first quarter of 2016 was $1,179,000, compared to $1,000,000 in the first quarter of 2015, representing an increase of $179,000, or 17.9%.

Most significantly impacting the comparative first quarter periods was a $113,000 gain from the sale of loans recorded in the first quarter of 2016; no similar corresponding gain was recorded in the 2015 period. Increases in customer service fees and debit card income of 6.3% and 18.5% respectively, were primarily due to the addition of deposit accounts from the FNBPA acquisition.

Commissions from the sales of non-deposit products decreased in the first quarter of 2016 by $20,000, or 22.2%, as sales activity decreased. Fees derived from loan activity increased by $19,000, or 55.9%, due primarily to an increase in title insurance fees.

The Company originates mortgages to sell on the secondary market, while retaining the servicing rights; the Company has built a servicing portfolio of approximately $21.6 million as of March 31, 2016. The mortgage servicing right asset, as of March 31, 2016, was $202,000. Mortgage banking income is made up of origination and servicing fees collected from the buyer, origination points collected from the borrower and an adjustment to the fair value of the mortgage servicing rights asset. In the first quarter of 2016, mortgage banking income was $35,000, a decrease of $19,000, or 35.1%, from the first quarter of 2015, due to lower activity.

Less significant changes in non-interest income categories included slight changes in earnings on bank-owned life insurance, trust fees, income from unconsolidated subsidiary and other miscellaneous income.

Net losses of $17,000 were realized on securities transactions in the first quarter of 2015. There were no such securities transactions in the first quarter of 2016.

As a percentage of average assets, annualized non-interest income, exclusive of net gains on the sale of securities, was 0.81% in the first quarter of 2016 as compared to 0.85% in the first quarter of 2015. Excluding the gain from the sale of loans mentioned above, the ratio in the first quarter of 2016 would have been 0.73%.

Non-interest Expense:

Total non-interest expense for the first quarter of 2016 was $536,000, or 14.9%, higher as compared to the first quarter of 2015. Expenses of $58,000, related to the aforementioned FNBPA acquisition were recorded in the first quarter of 2016 as compared to $10,000 in the prior year period. Merger costs will also be recorded through the remaining year as business integration continues. Excluding the merger and acquisition expenses, non-interest expense for the first quarter of 2016 was $4,082,000, an increase of 13.6% over the comparable first quarter of 2015, with most increases primarily due to costs associated with managing and operating a larger asset base. Employee compensation expense increased by $189,000, and employee benefits costs increased by $54,000, representing increases of 12.8% and 9.8%, respectively. Data processing expense and professional fees increased 16.8% and 32.5% respectively, in the first quarter of 2016 versus the first quarter of 2015. Premium expense for FDIC insurance increased by 20.7%, as a result of the increased asset size following the FNBPA transaction.

As a percentage of average assets, annualized non-interest expense was 2.83% in the first quarter of 2016 compared to 3.03% in the first quarter of 2015. Excluding merger and acquisition expenses, annualized non-interest expense as a percentage of average assets was 2.79% in the first quarter of 2016 and 3.02% in the first quarter of 2015.

Provision for income taxes:

Income tax expense in the first quarter of 2016 was $255,000 as compared to the $83,000 recorded in the first quarter of 2015. The Company qualifies for a federal tax credit for a low-income housing project investment, and the tax provisions for each period reflect the application of the tax credit. For the first quarter of 2016, the tax credit lowered the effective tax rate from 25.7% to 16.5%. In the first quarter of 2015, the tax credit lowered the effective tax rate from 22.5% to 8.2%.

Liquidity:

The objective of liquidity management is to ensure that sufficient funding is available, at a reasonable cost, to meet the ongoing operational cash needs of the Company and to take advantage of income producing opportunities as they arise. While the desired level of liquidity will vary depending upon a variety of factors, it is the primary goal of the Company to maintain a high level of liquidity in all economic environments. Principal sources of asset liquidity are provided by loans and securities maturing in one year or less, and other short-term investments, such as federal funds sold and cash and due from banks. Liability liquidity, which is more difficult to measure, can be met by attracting deposits and maintaining the core deposit base. The Company is a member of the Federal Home Loan Bank of Pittsburgh for the purpose of providing short-term liquidity when other sources are unable to fill these needs. During the first three months of 2016, overnight borrowings from the Federal Home Loan Bank averaged $28,574,000. As of March 31, 2016, the Company had short term borrowings and long-term debt with the Federal Home Loan Bank of $4,100,000 and $32,500,000, respectively, and had remaining unused borrowing capacity with the Federal Home Loan Bank of $129.7 million.

Funding derived from securities sold under agreements to repurchase (accounted for as collateralized financing transactions) is available through corporate cash management accounts for business customers. This product gives the Company the ability to pay interest on corporate checking accounts.

In view of the sources previously mentioned, management believes that the Company's liquidity is capable of providing the funds needed to meet operational cash needs.

Off-Balance Sheet Arrangements:

The Company’s consolidated financial statements do not reflect various off-balance sheet arrangements that are made in the normal course of business, which may involve some liquidity risk, credit risk, and interest rate risk. These commitments consist mainly of loans approved but not yet funded, unused lines of credit and outstanding letters of credit. Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Generally, financial and performance letters of credit have expiration dates within one year of issuance, while commercial letters of credit have longer term commitments. The credit risk involved in issuing letters of credit is essentially the same as the risks that are involved in extending loan facilities to customers. The Company generally holds collateral and/or personal guarantees supporting these commitments. The Company had $2,464,000 and $2,586,000 of financial and performance letters of credit commitments outstanding as of March 31, 2016 and December 31, 2015, respectively. Commercial letters of credit as of March 31, 2016 and December 31, 2015 totaled $11,900,000. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of March 31, 2016 for payments under letters of credit issued was not material. Because these instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk.

Additionally, the Company has committed to fund and sell qualifying residential mortgage loans to the Federal Home Loan Bank of Pittsburgh in the total amount of $10,000,000. As of March 31, 2016, $8,290,000 remained to be delivered on that commitment, none of which has been committed to borrowers.

The Company has no investment in or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity or the availability of capital resources.

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Interest Rate Sensitivity:

Interest rate sensitivity management is overseen by the Asset/Liability Management Committee. This process involves the development and implementation of strategies to maximize net interest margin, while minimizing the earnings risk associated with changing interest rates. Traditional gap analysis identifies the maturity and re-pricing terms of all assets and liabilities. A simulation analysis is used to assess earnings and capital at risk from movements in interest rates. See Item 3 for a description of the complete simulation process and results.

Capital Adequacy:

Bank regulatory authorities in the United States issue risk-based capital standards. These capital standards relate a banking company's capital to the risk profile of its assets and provide the basis by which all banking companies and banks are evaluated in terms of capital adequacy. Effective January 1, 2015, the risk-based capital rules were modified subject to a transition period for several aspects of the final rules, including the new minimum capital ratio requirements, the capital conservation buffer and the regulatory capital adjustments and deductions. The new framework is commonly called "BASEL III". The final rules revised federal regulatory agencies' risk-based and leverage capital requirements and their method for calculating risk-weighted assets to make them consistent with the Basel III framework. The final rules apply to all depository institutions, top-tier bank holding companies with total consolidated assets of $500 million or more, and top-tier savings and loan holding companies ("banking organizations"). Among other things, the rules established a new common equity tier 1 (CET1) minimum capital requirement (4.5% of risk-weighted assets) and a higher minimum tier 1 capital requirement (from 4.0% to 6.0% of risk-weighted assets), and assign higher risk weightings (150%) to exposures that are more than 90 days past due or are on nonaccrual status and certain commercial real estate facilities that finance the acquisition, development or construction of real property.

Basel III requires financial institutions to maintain: (a) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7.0%); (b) a minimum ratio of tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum tier 1 capital ratio of 8.5% upon full implementation); (c) a minimum ratio of total (that is, tier 1 plus tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation); and (d) a minimum leverage ratio of 3.0%, calculated as the ratio of tier 1 capital balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter). In addition, the proposed rules also limit a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer".

According to the rules, CET1 is comprised of common stock plus related surplus, net of treasury stock and other contra-equity components, retained earnings and accumulated other comprehensive income. However, certain banking institutions, including the Bank, were permitted to make a one-time election to opt out of the requirement to include most components of AOCI in CET1. This opt-out option was available only on March 31, 2015. The Bank elected to opt-out. At March 31, 2016, the Bank exceeded the regulatory requirements to be considered a "well capitalized" financial institution under the new rules.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk is the exposure to economic loss that arises from changes in the values of certain financial instruments. The types of market risk exposures generally faced by financial institutions include equity market price risk, interest rate risk, foreign currency risk and commodity price risk. Due to the nature of its operations, only equity market price risk and interest rate risk are significant to the Company.

Equity market price risk is the risk that changes in the values of equity investments could have a material impact on the financial position or results of operations of the Company. The Company’s equity investments consist of common stocks of publicly traded financial institutions.

Declines and volatility in the values of financial institution stocks in the last several years have significantly reduced the likelihood of realizing significant gains in the near-term. Although the Company has realized occasional gains from this portfolio in the past, the primary objective of the portfolio is to achieve value appreciation in the long term while earning consistently attractive after-tax yields from dividends. The carrying value of the financial institutions stocks accounted for 0.4% of the Company's total assets as of March 31, 2016. Management performs an impairment analysis on the entire investment portfolio, including the financial institutions stocks, on a quarterly basis. For the three months ended March 31, 2016, no "other-than-temporary" impairment was identified. There is no assurance that declines in market values of the common stock portfolio in the future will not result in "other-than-temporary" impairment charges, depending upon facts and circumstances present.

The equity investments in the Company's portfolio had an adjusted cost basis of approximately $1,692,000 and a fair value of $2,224,000 at March 31, 2016. Net unrealized gains in this portfolio were approximately $532,000 at March 31, 2016.

In addition to its equity portfolio, the Company's investment management and trust services revenue could be impacted by fluctuations in the securities markets. A portion of the Company's trust revenue is based on the value of the underlying investment portfolios. If securities values decline, the Company's trust revenue could be negatively impacted.

Interest rate risk creates exposure in two primary areas. First, changes in rates have an impact on the Company's liquidity position and could affect its ability to meet obligations and continue to grow. Second, movements in interest rates can create fluctuations in the Company's net interest income and changes in the economic value of equity.

The primary objective of the Company's asset-liability management process is to maximize current and future net interest income within acceptable levels of interest rate risk while satisfying liquidity and capital requirements. Management recognizes that a certain amount of interest rate risk is inherent, appropriate and necessary to ensure profitability. A simulation analysis is used to assess earnings and capital at risk from movements in interest rates. The model considers three major factors: (1) volume differences; (2) repricing differences; and (3) timing in its income simulation. As of the most recent model run, data was disseminated into appropriate repricing buckets, based upon the static position at that time. The interest-earning assets and interest-bearing liabilities were assigned a multiplier to simulate how much that particular balance sheet item would re-price when interest rates change. Finally, the estimated timing effect of rate changes is applied, and the net interest income effect is determined on a static basis (as if no other factors were present). As the table below indicates, based upon rate shock simulations on a static basis, the Company's balance sheet is relatively rate-neutral as rates decline. Over a one-year period, the net effect of an immediate 100, 200, 300 and 400 basis point rate increase would change net interest income by $157,000, $300,000, $(1,006,000) and $(1,368,000), respectively. As the table below indicates, the net effect of interest rate risk on net interest income is minimal in a rising rate environment through a 200 basis point increase. The Company's rate risk policies provide for maximum limits on net interest income that can be at risk for 100 through 400 basis point changes in interest rates.

Effect of Interest Rate Risk on Net Interest Income
(Dollars in thousands)

Change in Interest Rates (Basis Points)	Total Change in Net Interest Income
400	$ (1,368)
300	(1,006)
200	300
100	157
0	-
(100)	188
(200)	152
(300)	93
(400)	(141)

The net interest income at risk position remained within the guidelines established by the Company’s asset/liability policy.

No material change has been noted in the Bank’s equity value at risk. Please refer to the Annual Report on Form 10-K as of December 31, 2015 for further discussion of this topic.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

As of March 31, 2016, the Company carried out an evaluation, under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined by the Securities Exchange Act of 1934 (“Exchange Act”), Rule 13a-15(e). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. These controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files under the Exchange Act is accumulated and communicated to the issuer’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Based upon that evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential conditions, regardless of how remote.

Attached as Exhibits 31 and 32 to this quarterly report are certifications of the Chief Executive Officer and the Chief Financial Officer required by Rule 13a-14(a) and rule 15d-14(a) of the Exchange Act. This portion of the Company’s quarterly report includes the information concerning the controls evaluation referred to in the certifications and should be read in conjunction with the certifications for a more complete understanding of the topics presented.

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Changes in Internal Control Over Financial Reporting

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

PART II - OTHER INFORMATION