SUSSEX BANCORP
Form 10-Q
May 10, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2017

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ___________to ________

Commission File Number 0-29030

SUSSEX BANCORP
(Exact name of registrant as specified in its charter)

New Jersey	22-3475473
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 Enterprise Drive, Suite 700, Rockaway, NJ	07866
(Address of principal executive offices)	(Zip Code)

(844) 256-7328
(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 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	Accelerated filer	Non-accelerated filer	Smaller reporting company x
		(Do not check if a smaller reporting company)	

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

As of May 4, 2017 there were 4,791,003 shares of common stock, no par value, outstanding.

SUSSEX BANCORP
FORM 10-Q

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FORWARD-LOOKING STATEMENTS

We may, from time to time, make written or oral “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, including statements contained in our filings with the Securities and Exchange Commission (the “SEC”), our reports to shareholders and in other communications by us. This Report on Form 10-Q contains “forward-looking statements” which may be identified by the use of such words as “believe,” “expect,” “anticipate,” “should,” “planned,” “estimated” and “potential.” Examples of forward-looking statements include, but are not limited to, estimates with respect to our financial condition, results of operation and business that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, but are not limited to:

- changes in the interest rate environment that reduce margins;
- changes in the regulatory environment;
- the highly competitive industry and market area in which we operate;
- general economic conditions, either nationally or regionally, resulting in, among other things, a deterioration in credit quality;
- changes in business conditions and inflation;
- changes in credit market conditions;
- changes in the securities markets which affect investment management revenues;
- increases in Federal Deposit Insurance Corporation (“FDIC”) deposit insurance premiums and assessments could adversely affect our financial condition;
- changes in technology used in the banking business;
- the soundness of other financial services institutions which may adversely affect our credit risk;
- our controls and procedures may fail or be circumvented;
- new lines of business or new products and services which may subject us to additional risks;
- changes in key management personnel which may adversely impact our operations;
- the effect on our operations of recent legislative and regulatory initiatives that were or may be enacted in response to the ongoing financial crisis;
- severe weather, natural disasters, acts of war or terrorism and other external events which could significantly impact our business;
- the factors that could also cause actual results to differ materially from current expectations include failure to complete the proposed Merger (as defined herein), the imposition of adverse regulatory conditions in connection with regulatory approval of the proposed Merger, disruption to the parties' businesses as a result of the announcement and pendency of the Merger, the inability to realize expected cost savings or to implement integration plans and other adverse consequences associated with the Merger; and
- other factors detailed from time to time in our filings with the SEC.

Although we believe that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from the results discussed in these forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We do not undertake any obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

PART I – FINANCIAL INFORMATION
Item 1 – Financial Statements
SUSSEX BANCORP
CONSOLIDATED BALANCE SHEETS
(Unaudited)

(Dollars in Thousands)	March 31, 2017	December 31, 2016
ASSETS		
Cash and due from banks	$3,051	$ 2,847
Interest-bearing deposits with other banks	4,637	11,791
Cash and cash equivalents	7,688	14,638
Interest bearing time deposits with other banks	100	100
Securities available for sale, at fair value	99,797	88,611
Securities held to maturity, at amortized cost (fair value of $8,788 and $11,739 at March 31, 2017 and December 31, 2016, respectively)	8,630	11,618
Federal Home Loan Bank Stock, at cost	4,269	5,106
Loans receivable, net of unearned income	718,800	695,257
Less: allowance for loan losses	6,797	6,696
Net loans receivable	712,003	688,561
Foreclosed real estate	2,464	2,367
Premises and equipment, net	8,505	8,728
Accrued interest receivable	2,006	2,058
Goodwill	2,820	2,820
Bank-owned life insurance	16,638	16,532
Other assets	7,362	7,589
Total Assets	$872,282	$ 848,728
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Non-interest bearing	$130,130	$ 132,434
Interest bearing	566,446	528,487
Total deposits	696,576	660,921
Short-term borrowings	14,800	29,805
Long-term borrowings	66,000	66,000
Accrued interest payable and other liabilities	4,643	4,090
Subordinated debentures	27,841	27,840
Total Liabilities	809,860	788,656
Stockholders' Equity:		
Preferred stock, no par value, 1,000,000 shares authorized; none issued	—	—
Common stock, no par value, 10,000,000 shares authorized; 4,785,159 and 4,741,068 shares issued and outstanding	36,703	36,538
Deferred compensation obligation under Rabbi Trust	(1,272)	(1,383)

Retained earnings	25,111	23,291
Accumulated other comprehensive income	608	243
Stock held by Rabbi Trust	1,272	1,383
Total Stockholders' Equity	62,422	60,072
Total Liabilities and Stockholders' Equity	$ 872,282	$ 848,728

See Notes to Consolidated Financial Statements

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SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(Unaudited)

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(Dollars in thousands except per share data)	Three Months Ended March 31, 2017	2016
INTEREST INCOME		
Loans receivable, including fees	$7,598	$6,145
Securities:		
Taxable	341	376
Tax-exempt	313	201
Interest bearing deposits	16	4
Total Interest Income	8,268	6,726
INTEREST EXPENSE		
Deposits	717	575
Borrowings	481	437
Subordinated debentures	321	68
Total Interest Expense	1,519	1,080
Net Interest Income	6,749	5,646
PROVISION FOR LOAN LOSSES	407	211
Net Interest Income after Provision for Loan Losses	6,342	5,435
OTHER INCOME		
Service fees on deposit accounts	253	225
ATM and debit card fees	180	187
Bank-owned life insurance	106	76
Insurance commissions and fees	1,747	1,721
Investment brokerage fees	3	27
Net gain on sales of securities	107	167
Net (loss) on disposal of premises and equipment	—	(13)
Other	81	134
Total Other Income	2,477	2,524
OTHER EXPENSES		
Salaries and employee benefits	3,558	3,353
Occupancy, net	500	424
Data processing	557	549
Furniture and equipment	240	233
Advertising and promotion	106	105
Professional fees	277	174
Director fees	107	59
FDIC assessment	51	120
Insurance	66	73
Stationary and supplies	32	52
Loan collection costs	24	32
Net expenses and write-downs related to foreclosed real estate	45	75
Other	414	361
Total Other Expenses	5,977	5,610
Income before Income Taxes	2,842	2,349
EXPENSE FOR INCOME TAXES	831	775
Net Income	2,011	1,574
OTHER COMPREHENSIVE INCOME:		
Unrealized gains on available for sale securities arising during the period	676	985
Fair value adjustments on derivatives	40	(400)

Reclassification adjustment for net gain on securities transactions included in net income	(107)	(167)
Income tax related to items of other comprehensive (loss) income	(244)	(167)
Other comprehensive income, net of income taxes	365	251
Comprehensive income	$2,376	$1,825
EARNINGS PER SHARE		
Basic	$0.43	$0.34
Diluted	$0.43	$0.34

See Notes to Consolidated Financial Statements

SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Three Months Ended March 31, 2017 and 2016
(Unaudited)

(Dollars in Thousands)	Number of Shares Outstanding	Common Stock	Deferred Compensation Obligation Under Rabbi Trust	Retained Earnings	Accumulated Other Comprehensive Income	Stock Held by Rabbi Trust	Treasury Stock	Total Stockholders' Equity
Balance December 31, 2015	4,646,238	$ 35,927	—	$ 18,520	$ 86	—	$ (592)	$ 53,941
Net income	—	—	—	1,574	—	—	—	1,574
Other comprehensive income	—	—	—	—	251	—	—	251
Treasury shares purchased	—	—	—	—	—	—	—	—
Restricted stock granted	30,822	—	—	—	—	—	—	—
Restricted stock forfeited	(1,084)	—	—	—	—	—	—	
Compensation expense related to stock option and restricted stock grants	—	101	—	—	—	—	—	101
Dividends declared on common stock ($0.04 per share)	—	—	—	(185)	—	—	—	(185)
Balance March 31, 2016	4,675,976	$ 36,028	$ —	$ 19,909	$ 337	$—	$ (592)	$ 55,682
Balance December 31, 2016	4,741,068	$ 36,538	1,383	$ 23,291	$ 243	(1,383)	$ —	$ 60,072
Net income	—	—	—	2,011	—		—	2,011
Other comprehensive income	—	—	—	—	365	—	—	365
Treasury shares purchased	—	—	—	—	—		—	—
Funding of Supplemental Director Retirement Plan	—	—	(111)	—	—	111	—	—
Options exercised	—	—	—	—	—		—	—
Restricted stock granted	47,326	—	—	—	—		—	—
Restricted stock forfeited	(3,235)	—	—	—	—	—	—	—
Compensation expense related to stock option and restricted stock grants	—	165	—	—	—		—	165
Dividends declared on common stock ($0.04 per share)	—	—	—	(191)	—		—	(191)
Balance March 31, 2017	4,785,159	$ 36,703	$ 1,272	$ 25,111	$ 608	$ (1,272)	$ —	$ 62,422

See Notes to Consolidated Financial Statements

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SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
(Dollars in thousands)	2017	2016
Cash Flows from Operating Activities		
Net income	$2,011	$1,574
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	407	211
Depreciation and amortization	272	258
Net amortization of securities premiums and discounts	410	412
Amortization of subordinated debt issuance costs	1	—
Net realized gain on sale of securities	(107)	(167)
Net realized loss on disposal of premises and equipment	—	13
Net realized gain on sale of foreclosed real estate	(2)	(3)
Write-downs of and provisions for foreclosed real estate	36	—
Deferred income tax (benefit) expense	(82)	(192)
Earnings on bank-owned life insurance	(106)	(76)
Compensation expense for stock options and stock awards	165	101
(Decrease) increase in assets:		
Accrued interest receivable	52	(493)
Other assets	105	(726)
Increase in accrued interest payable and other liabilities	553	904
Net Cash Provided by Operating Activities	3,715	1,816
Cash Flows from Investing Activities		
Securities available for sale:		
Purchases	(25,368)	(2,044)
Sales	12,303	8,088
Maturities, calls and principal repayments	2,152	1,789
Securities held to maturity:		
Purchases	—	(480)
Maturities, calls and principal repayments	2,981	491
Net increase in loans	(23,982)	(36,617)
Proceeds from the sale of foreclosed real estate	2	29
Purchases of bank premises and equipment	(49)	(518)
Net decrease in Federal Home Loan Bank stock	837	1,326
Net Cash Used in Investing Activities	(31,124)	(27,936)
Cash Flows from Financing Activities		
Net increase in deposits	35,655	57,444
Net decrease in short-term borrowed funds	(15,005)	(33,220)
Proceeds from long-term borrowings	—	5,000
Dividends paid	(191)	(185)
Net Cash Provided by Financing Activities	20,459	29,039
Net (Decrease) increase in Cash and Cash Equivalents	(6,950)	2,919
Cash and Cash Equivalents - Beginning	14,638	6,120
Cash and Cash Equivalents - Ending	$7,688	$9,039

Supplementary Cash Flows Information

Interest paid	$1,531	$975
Income taxes paid	$20	$795
Supplementary Schedule of Noncash Investing and Financing Activities		
Foreclosed real estate acquired in settlement of loans	$133	$—

See Notes to Consolidated Financial Statements

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NOTE 1 – SUMMARY OF SIGNIFICANT ACOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of Sussex Bancorp ("we," "us," "our" or the "company") and our wholly owned subsidiary Sussex Bank (the "Bank"). The Bank's wholly owned subsidiaries are SCB Investment Company, Inc., SCBNY Company, Inc., ClassicLake Enterprises, LLC, PPD Holding Company, LLC, and Tri-State Insurance Agency, Inc. ("Tri-State"), a full service insurance agency located in Sussex County, New Jersey with a satellite office located in Bergen County, New Jersey. Tri-State's operations are considered a separate segment for financial disclosure purposes. All inter-company transactions and balances have been eliminated in consolidation. The Bank operates eleven banking offices, eight located in Sussex County, New Jersey, one located in Bergen County, New Jersey, one located in Warren County, New Jersey, and one in Queens County, New York.

We are subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the "FRB"). The Bank's deposits are insured by the Deposit Insurance Fund ("DIF") of the FDIC up to applicable limits. The operations of the company and the Bank are subject to the supervision and regulation of the FRB, the FDIC and the New Jersey Department of Banking and Insurance (the "Department") and the operations of Tri-State are subject to supervision and regulation by the Department.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by the accounting principles generally accepted in the United States of America ("U.S. GAAP") for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the three month period ended March 31, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

New Accounting Standards

In May 2014, the FASB issued an Accounting Standard Update ("ASU") 2014-09 to amend its guidance on "Revenue from Contracts with Customers (Topic 606). The objective of the ASU is to align the recognition of revenue with the transfer of promised goods or services provided to customers in an amount that reflects the consideration which the entity expects to be entitled in exchange for those goods or services. This ASU will replace most existing revenue recognition guidance under GAAP when it becomes effective. In August 2015, the FASB issued an amendment (ASU 2015-14) which defers the effective date of this new guidance by one year. More detailed implementation guidance on Topic 606 was issued in March 2016 (ASU 2016-08), April 2016 (ASU 2016-10) May 2016 (ASU 2016-12) and December 2016 (ASU 2016-20), and the effective date and transition requirements for these ASUs are the same as the effective date and transition requirements of ASU 2014-09. The amendments in ASU 2014-09 are effective for public business entities for annual periods beginning after December 15, 2017. The Company currently believes the impact of adopting the standard, as modified and augmented by subsequently issued pronouncements, will not be material to either past or future periods as it relates to the Company's core banking revenue streams, but is still evaluating the potential impact the new standard will have on noninterest income components.

In January 2016, FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things; (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. For public entities, the guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted for all public business entities upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company currently expects that upon adoption of ASU 2016-02, right-of-use assets and lease liabilities will be recognized in the consolidated balance sheet in amounts that will be material; however, there will be no material impact on operations.

In March 2016, FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. FASB issued ASU 2016-09 as part of its initiative to reduce complexity in accounting standards. The areas for simplification in this ASU 2016-09 involve several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. For public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The Company`s adoption of the ASU did not have a significant impact on the Company`s consolidated financial statements. The effective tax rate decreased 3.8% to 29.2% from 33.0% for the quarters ended March 31, 2017 and 2016, respectively. The Company expects the annualized tax rate to be minimally impacted by the adoption of the ASU.

In June, 2016, the FASB issued Accounting Standards Update 2016-13, Financial Instruments – Credit Losses (Topic 326) (the "ASU"), which introduces new guidance for the accounting for credit losses on instruments within its scope. The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale (AFS) debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination. The ASU will be effective for public business entities that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities will have one additional year. Early application of the guidance will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements. The Company has taken steps to prepare for implementation when it becomes effective, such as changes to its current model and evaluating the potential use of outside professionals for an updated model.

In August 2016, FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force), which addresses eight classification issues related to the statement of cash flows; (i) debt prepayment or debt extinguishment costs, (ii) settlement of zero-coupon bonds, (iii) contingent consideration payments made after a business combination, (iv) proceeds from the settlement of insurance claims, (v) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, (vi) distributions received from equity method investees, (vii) beneficial interests in securitization transactions, and (viii) separately identifiable cash flows and application of the predominance principle. ASU 2016-15 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the ASU in an interim period, adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. Entities should apply this ASU using a retrospective transition method to each period presented. If it is impracticable for an entity to apply the ASU retrospectively for some of the issues, it may apply the amendments for those issues prospectively as of the earliest date practicable. The Company's adoption of the ASU will not have a significant impact on the Company's consolidated financial statements.

In January 2017, FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment (Topic 350). The main objective of this ASU is to simplify the accounting for goodwill impairment by requiring impairment charges be based upon the first step in the current two-step impairment test under Accounting Standards Codification (ASC) 350. Currently, if the fair value of a reporting unit is lower than its carrying amount (Step 1), an entity calculates any impairment charge by comparing the implied fair value of goodwill with its carrying amount (Step 2). This ASU’s objective is to simplify how all entities assess goodwill for impairment by eliminating Step 2 from the goodwill impairment test. As amended, the goodwill impairment test will consist of one step comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value. The standard will be applied prospectively

and is effective for annual and interim impairment tests performed in periods beginning after December 15, 2019. Early adoption is permitted for annual and interim goodwill impairment testing dates after January 1, 2017. The Company is currently evaluating the impact of the pending adoption on its consolidated financial statements.
In March 2017, FASB issued ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities (Subtopic 310-20). The update shortens the amortization period for premiums on purchased callable debt securities to the earliest call date. The amendment will apply only to callable debt securities with explicit, noncontingent call features that are callable at fixed prices and on preset dates, apply to all premiums on callable debt securities, regardless of how they were generated, and require companies to reset the effective yield using the payment terms of the debt security if the call option is not exercised on the earliest call date. The ASU does not require an accounting change for securities held at a discount. The discount continues to be amortized to maturity and does not apply when the investor has already incorporated prepayments into the calculation of its effective yield under other GAAP. The amendments in the ASU are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those years.Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The Company's adoption of the ASU will not have a significant impact on the Company's consolidated financial statements.

NOTE 2 – SECURITIES

Available for Sale

The amortized cost and approximate fair value of securities available for sale as of March 31, 2017 and December 31, 2016 are summarized as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2017				
U.S. government agencies	$ 22,304	$ 34	$ (94)	$ 22,244
State and political subdivisions	40,681	282	(524)	40,439
Mortgage-backed securities -				
U.S. government-sponsored enterprises	35,485	146	(550)	35,081
Corporate Debt	2,000	33	—	2,033
	$ 100,470	$ 495	$ (1,168)	$ 99,797
December 31, 2016				
U.S. government agencies	$ 13,115	$ 29	$ (57)	$ 13,087
State and political subdivisions	41,255	203	(770)	40,688
Mortgage-backed securities -				
U.S. government-sponsored enterprises	33,483	126	(755)	32,854
Corporate Debt	2,000	—	(18)	1,982
	$ 89,853	$ 358	$ (1,600)	$ 88,611

Securities with a carrying value of approximately $47.1 million and $34.3 million at March 31, 2017 and December 31, 2016, respectively, were pledged to secure public deposits and for borrowings at the Federal Reserve Bank as required or permitted by applicable laws and regulations.

The amortized cost and fair value of securities available for sale at March 31, 2017 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments which pay principal on a periodic basis are not included in the maturity categories.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	$—	$—
Due after one year through five years	199	200
Due after five years through ten years	4,255	4,276
Due after ten years	38,227	37,996
Total bonds and obligations	42,681	42,472
U.S. government agencies	22,304	22,244
Mortgage-backed securities:		
U.S. government-sponsored enterprises	35,485	35,081
Total available for sale securities	$ 100,470	$99,797

Gross gains on sales of securities available for sale were $146 thousand and $167 thousand for the three months ended March 31, 2017 and 2016, respectively. Gross realized losses on sales of securities available for sale were $39 thousand and less than $1 thousand for the three months ended March 31, 2017 and 2016, respectively.

Temporarily Impaired Securities
The following table shows gross unrealized losses and fair value of securities with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by category and length of time that individual available for sale securities have been in a continuous unrealized loss position at March 31, 2017 and December 31, 2016.

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
March 31, 2017						
U.S. government agencies	$11,199	$ (53)	$2,067	$ (41)	$13,266	$ (94)
State and political subdivisions	14,930	(524)	—	—	14,930	(524)
Mortgage-backed securities -						
U.S. government-sponsored enterprises	24,538	(549)	540	(1)	25,078	(550)
Corporate Debt	—	—	—	—	—	—
Total temporarily impaired securities	$50,667	$ (1,126)	$2,607	$ (42)	$53,274	$ (1,168)
December 31, 2016						
U.S. government agencies	$4,952	$(15)	$2,126	$(42)	$7,078	$(57)
State and political subdivisions	23,989	(770)	—	—	23,989	(770)
Mortgage-backed securities -						
U.S. government-sponsored enterprises	23,299	(752)	639	(3)	23,938	(755)
Corporate Debt	1,982	(18)	—	—	1,982	(18)
Total temporarily impaired securities	$54,222	$(1,555)	$2,765	$(45)	$56,987	$(1,600)

For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred. As of March 31, 2017, we reviewed our available for sale securities portfolio for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt and equity securities are evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position.

U.S. Government Agencies

At March 31, 2017 and December 31, 2016, the declines in fair value and the unrealized losses for our U.S. government agencies securities were primarily due to changes in spreads and market conditions and not credit quality. At March 31, 2017, there

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were eight securities with a fair value of $13.3 million that had an unrealized loss that amounted to $94 thousand. As of March 31, 2017, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of the U.S. government agency securities at March 31, 2017 were deemed to be other-than-temporarily impaired ("OTTI").

At December 31, 2016, there were five securities with a fair value of $7.1 million that had an unrealized loss that amounted to $57 thousand.

State and Political Subdivisions
At March 31, 2017 and December 31, 2016, the decline in fair value and the unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At March 31, 2017, there were seventeen securities with a fair value of $14.9 million that had an unrealized loss that amounted to $524 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates.

At December 31, 2016, there were thirty-one securities with a fair value of $24.0 million that had an unrealized loss that amounted to $770 thousand.

Mortgage-Backed Securities
At March 31, 2017 and December 31, 2016, the decline in fair value and the unrealized losses for our mortgage-backed securities guaranteed by U.S. government-sponsored enterprises were primarily due to changes in spreads and market conditions and not credit quality. At March 31, 2017, there were seventeen securities with a fair value of $25.1 million that had an unrealized loss that amounted to $550 thousand. As of March 31, 2017, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of our mortgage-backed securities at March 31, 2017 were deemed to be OTTI.

At December 31, 2016, there were sixteen securities with a fair value of $23.9 million that had an unrealized loss that amounted to $755 thousand.

Corporate Debt
At March 31, 2017, the decline in fair value and unrealized losses for our corporate debt was caused by changes in interest rates and spreads and were not the result of credit quality. At March 31, 2017, there were no securities that had an unrealized loss. These securities typically have maturity dates greater than five years and the fair values are more sensitive to changes in market interest rates. As of March 31, 2017, we did not intend to sell and it was more-likely-than-no that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of our corporate debt as March 31, 2017, were deemed to be other-than-temporarily-impaired.

At December 31, 2016, there was one security with a fair value of $2.0 million that had an unrealized loss that amounted to $18 thousand.

Held to Maturity Securities

The amortized cost and approximate fair value of securities held to maturity as of March 31, 2017 and December 31, 2016 are summarized as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value

March 31, 2017				
State and political subdivisions	$ 8,630	$ 158	$ —	$ 8,788
December 31, 2016				
State and political subdivisions	$ 11,618	$ 123	$ (2)	$ 11,739

The amortized cost and carrying value of securities held to maturity at March 31, 2017 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 5,783	$5,783
Due after one year through five years	—	—
Due after five years through ten years	1,808	1,871
Due after ten years	1,039	1,134
Total held to maturity securities	$ 8,630	$8,788

Temporarily Impaired Securities

For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred. As of March 31, 2017, we did not have any held to maturity investments with unrealized losses. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt securities is evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position. For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred.

At December 31, 2016, there were two securities with a fair value of $789 thousand that had an unrealized loss of $2 thousand.

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2016						
State and political subdivisions	$789	$ (2)	$ —	$ —	$789	$ (2)
Total temporarily impaired securities	$789	$ (2)	$ —	$ —	$789	$ (2)

NOTE 3 – LOANS

The composition of net loans receivable at March 31, 2017 and December 31, 2016 is as follows:

(Dollars in thousands)	March 31, 2017	December 31, 2016
Commercial and industrial	$35,906	$ 40,280
Construction	35,662	25,360
Commercial real estate	485,617	479,227
Residential real estate	161,543	150,237
Consumer and other	962	1,038
Total loans receivable	719,690	696,142
Unearned net loan origination fees	(890)	(885)
Allowance for loan losses	(6,797)	(6,696)
Net loans receivable	$712,003	$ 688,561

Mortgage loans serviced for others are not included in the accompanying balance sheets. The total amount of loans serviced for the benefit of others was approximately $246 thousand and $249 thousand at March 31, 2017 and December 31, 2016, respectively. Mortgage servicing rights were immaterial at March 31, 2017 and December 31, 2016.

NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY OF FINANCING RECEIVABLES

The following table presents changes in the allowance for loan losses disaggregated by the class of loans receivable for the three ended March 31, 2017 and 2016:

(Dollars in thousands)	Commercial and Industrial	Construction	Commercial Real Estate	Residential Real Estate	Consumer and Other	Unallocated	Total
Three Months Ended:							
March 31, 2017							
Beginning balance	$ 110	$ 359	$ 3,932	$ 899	$ 19	$ 1,377	$6,696
Charge-offs	(13)	—	(266)	(34)	(5)	—	(318)
Recoveries	—	—	2	8	2	—	12
Provision	(5)	66	357	52	1	(64)	407
Ending balance	$ 92	$ 425	$ 4,025	$ 925	$ 17	$ 1,313	$6,797
March 31, 2016							
Beginning balance	$ 85	$ 220	$ 3,646	$ 784	$ 87	$ 768	$5,590
Charge-offs	—	—	—	(9)	(19)	—	(28)
Recoveries	7	—	31	—	1	—	39
Provision	6	47	170	133	52	(197)	211
Ending balance	$ 98	$ 267	$ 3,847	$ 908	$ 121	$ 571	$5,812

The following table presents the balance of the allowance of loan losses and loans receivable by class at March 31, 2017 and December 31, 2016 disaggregated on the basis of our impairment methodology.

	Allowance for Loan Losses			Loans Receivable		
(Dollars in thousands)	Balance	Balance Loans Individually Evaluated for Impairment	Balance Related to Loans Collectively Evaluated for Impairment	Balance	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
March 31, 2017						
Commercial and industrial	$92	$ —	$ 92	$35,906	$ 19	$ 35,887
Construction	425	—	425	35,662	—	35,662
Commercial real estate	4,025	31	3,994	485,617	4,302	481,315
Residential real estate	925	7	918	161,543	1,714	159,829
Consumer and other loans	17	—	17	962	—	962
Unallocated	1,313	—	—	—	—	—
Total	$6,797	$ 38	$ 5,446	$719,690	$ 6,035	$ 713,655
December 31, 2016						
Commercial and industrial	$110	$14	$96	$40,280	$33	$40,247
Construction	359	—	359	25,360	—	25,360
Commercial real estate	3,932	135	3,797	479,227	4,597	474,630
Residential real estate	899	6	893	150,237	1,967	148,270
Consumer and other loans	19	—	19	1,038	—	1,038
Unallocated	1,377	—	—	—	—	—
Total	$6,696	$155	$5,164	$696,142	$6,597	$689,545

An age analysis of loans receivable, which were past due as of March 31, 2017 and December 31, 2016, is as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 days Past Due	Greater Than 90 Days (a)	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
March 31, 2017							
Commercial and industrial	$—	$—	$123	$123	$35,783	$ 35,906	$ 104
Construction	—	—	—	—	35,662	35,662	—
Commercial real estate	1,233	105	3,843	5,181	480,436	485,617	—

Residential real estate	823	—	1,586	2,409	159,134	161,543	—
Consumer and other	5	—	—	5	957	962	—
Total	$2,061	$105	$5,552	$7,718	$711,972	$ 719,690	$ 104
December 31, 2016							
Commercial and industrial	$—	$—	$137	$137	$40,143	$40,280	$104
Construction	—	—	309	309	25,051	25,360	309
Commercial real estate	84	719	4,103	4,906	474,321	479,227	55
Residential real estate	786	247	1,752	2,785	147,452	150,237	—
Consumer and other	4	—	—	4	1,034	1,038	—
Total	$874	$966	$6,301	$8,141	$688,001	$696,142	$468

(a) includes loans greater than 90 days past due and still accruing and non-accrual loans.

Loans for which the accrual of interest has been discontinued at March 31, 2017 and December 31, 2016 were:

(Dollars in thousands)	March 31, 2017	December 31, 2016
Commercial and industrial	$ 19	$ 33
Commercial real estate	3,843	4,048
Residential real estate	1,586	1,752
Total	$ 5,448	$ 5,833

In determining the adequacy of the allowance for loan losses, we estimate losses based on the identification of specific problem loans through our credit review process and also estimate losses inherent in other loans on an aggregate basis by loan type. The credit review process includes the independent evaluation of the loan officer assigned risk ratings by the Chief Credit Officer and a third party loan review company. Such risk ratings are assigned loss component factors that reflect our loss estimate for each group of loans. It is management's and the Board of Directors' responsibility to oversee the lending process to ensure that all credit risks are properly identified, monitored, and controlled, and that loan pricing, terms and other safeguards against non-performance and default are commensurate with the level of risk undertaken and is rated as such based on a risk-rating system. Factors considered in assigning risk ratings and loss component factors include: borrower specific information related to expected future cash flows and operating results, collateral values, financial condition and payment status; levels of and trends in portfolio charge-offs and recoveries; levels in portfolio delinquencies; effects of changes in loan concentrations and observed trends in the economy and other qualitative measurements.

Our risk-rating system is consistent with the classification system used by regulatory agencies and with industry practices. Loan classifications of Substandard, Doubtful or Loss are consistent with the regulatory definitions of classified assets. The classification system is as follows:

- Pass: This category represents loans performing to contractual terms and conditions and the primary source of repayment is adequate to meet the obligation. We have five categories within the Pass classification depending on strength of repayment sources, collateral values and financial condition of the borrower.

- Special Mention: This category represents loans performing to contractual terms and conditions; however the primary source of repayment or the borrower is exhibiting some deterioration or weaknesses in financial condition that could potentially threaten the borrowers' future ability to repay our loan principal and interest or fees due.

- Substandard: This category represents loans that the primary source of repayment has significantly deteriorated or weakened which has or could threaten the borrowers' ability to make scheduled payments. The weaknesses require close supervision by management and there is a distinct possibility that we could sustain some loss if the deficiencies are not corrected. Such weaknesses could jeopardize the timely and ultimate collection of our loan principal and interest or fees due. Loss may not be expected or evident, however, loan repayment is inadequately supported by current financial information or pledged collateral.

- Doubtful: Loans so classified have all the inherent weaknesses of a substandard loan with the added provision that collection or liquidation in full is highly questionable and not reasonably assured. The probability of at least partial loss is high, but extraneous factors might strengthen the asset to prevent loss. The validity of the extraneous factors must be continuously monitored. Once these factors are questionable the loan should be considered for full or partial charge-off.

- Loss: Loans so classified are considered uncollectible, and of such little value that their continuance as active assets is not warranted. Such loans are fully charged off.

The following tables illustrate our corporate credit risk profile by creditworthiness category as of March 31, 2017 and December 31, 2016:

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
March 31, 2017					
Commercial and industrial	$35,783	$ 104	$ —	$ 19	$35,906
Construction	35,662	—	—	—	35,662
Commercial real estate	470,313	6,531	8,773	—	485,617
Residential real estate	159,075	473	1,995	—	161,543
Consumer and other	962	—	—	—	962
	$701,795	$ 7,108	$ 10,768	$ 19	$719,690
December 31, 2016					
Commercial and industrial	$40,247	$—	$33	$—	$40,280
Construction	25,360	—	—	—	25,360
Commercial real estate	463,889	7,461	7,877	—	479,227
Residential real estate	147,526	584	2,127	—	150,237
Consumer and other	1,038	—	—	—	1,038
	$678,060	$8,045	$10,037	$—	$696,142

The following table reflects information about our impaired loans by class as of March 31, 2017 and December 31, 2016:

	March 31, 2017			December 31, 2016		
(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance

With no related allowance recorded:

Commercial and industrial	$19	$ 19	$ —	$ 19	$ 19	$ —
Commercial real estate	2,292	2,292	—	2,324	2,324	—
Residential real estate	1,446	1,446	—	1,604	1,629	—

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With an allowance recorded:						
Commercial and industrial	—	—	—	14	14	14
Commercial real estate	2,010	2,270	31	2,273	2,364	135
Residential real estate	268	307	7	363	363	6
Total:						
Commercial and industrial	19	19	—	33	33	14
Commercial real estate	4,302	4,562	31	4,597	4,688	135
Residential real estate	1,714	1,753	7	1,967	1,992	6
	$6,035	$6,334	$38	$6,597	$6,713	$155

The following table presents the average recorded investment and income recognized for the three ended March 31, 2017 and 2016:

(Dollars in thousands)	For the Three Months Ended March 31, 2017 Average Recorded Investment	Interest Income Recognized	For the Three Months Ended March 31, 2016 Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and industrial	$19	$ —	$20	$ —
Commercial real estate	2,308	—	2,446	8
Residential real estate	1,525	1	1,061	1
Total impaired loans without a related allowance	3,852	1	3,527	9
With an allowance recorded:				
Commercial and industrial	7	—	—	—
Commercial real estate	2,142	8	2,699	8
Residential real estate	316	—	379	—
Consumer and other	—	—	138	—
Total impaired loans with an allowance	2,465	8	3,216	8
Total impaired loans	$6,317	$ 9	$6,743	$ 17

We recognize interest income on performing impaired loans as payments are received. On non-performing impaired loans we do not recognize interest income as all payments are recorded as a reduction of principal on such loans.

Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, postponement or forgiveness of principal, forbearance or other actions intended to maximize collection. The concessions rarely result in the forgiveness of principal or accrued interest. In addition, we attempt to obtain additional collateral or guarantor support when modifying such loans. Non-accruing restructured loans may be returned to accrual status when there has been a sustained period of repayment performance (generally six consecutive months of payments) and both principal and interest are deemed collectible.

The following table presents the recorded investment in troubled debt restructured loans, based on payment performance status:

(Dollars in thousands)	Total

	Commercial Real Estate	Residential Real Estate	
March 31, 2017			
Performing	$ 459	$ 128	$587
Non-performing	2,243	—	2,243
Total	$ 2,702	$ 128	$2,830
December 31, 2016			
Performing	$550	$129	$679
Non-performing	2,258	—	2,258
Total	$2,808	$129	$2,937

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of March 31, 2017, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

There were no troubled debt restructurings that occurred during the three months ended March 31, 2017 and 2016.

There were no troubled debt restructurings for which there was a payment default within twelve months following the date of the restructuring for the three months ended March 31, 2017 and 2016.

We may obtain physical possession of residential real estate collateralizing a consumer mortgage loan via foreclosure on an in-substance repossession. As of March 31, 2017 and December 31, 2016, we did not hold any foreclosed residential real estate properties. In addition, as of March 31, 2017 and December 31, 2016, respectively, we had consumer loans with a carrying value of $640 thousand and $666 thousand collateralized by residential real estate property for which formal foreclosure proceedings were in process.

NOTE 5 – EARNINGS PER SHARE

Basic earnings per share are calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares (unvested restricted stock grants and stock options) had been issued, as well as any adjustment to income that would result from the assumed issuance of potential common shares that may be issued by us. Potential common shares related to stock options are determined using the treasury stock method.

(In thousands, except share and per share data)	Three Months Ended March 31, 2017			Three Months Ended March 31, 2016		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Shares Outstanding (weighted average)		4,685,553			4,578,598	
Shares held by Rabbi Trust		96,736			—	
Shares liability under deferred compensation agreement		(96,736)			—	
Basic earnings per share:						
Net earnings applicable to common stockholders	$2,011	4,685,553	$ 0.43	$1,574	4,578,598	$ 0.34
Effect of dilutive securities:						
Unvested stock awards	—	41,780		—	27,828	
Diluted earnings per share:						
Net income applicable to common stockholders and assumed conversions	$2,011	4,727,333	$ 0.43	$1,574	4,606,426	$ 0.34

There were 46,753 and 57,038 shares of unvested restricted stock awards and options outstanding during the three months ended March 31, 2017 and 2016, respectively, which were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive.

NOTE 6 – OTHER COMPREHENSIVE INCOME

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

The components of other comprehensive income, both before tax and net of tax, are as follows:

	Three Months Ended March 31, 2017			Three Months Ended March 31, 2016		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
(Dollars in thousands)						
Other comprehensive income (loss):						
Unrealized gains on available for sale securities	$676	$270	$406	$985	$394	$591
Fair value adjustments on derivatives	40	16	24	(400)	(160)	(240)
Reclassification adjustment for net gains on securities transactions included in net income	(107)	(42)	(65)	(167)	(67)	(100)
Total other comprehensive income	$609	$244	$365	$418	$167	$251

NOTE 7 – SEGMENT INFORMATION

Our insurance agency operations are managed separately from the traditional banking and related financial services that we also offer. The insurance agency operation provides commercial, individual, and group benefit plans and personal coverage.

	Three Months Ended March 31, 2017			Three Months Ended March 31, 2016		
	Banking and Financial Services	Insurance Services	Total	Banking and Financial Services	Insurance Services	Total
(Dollars in thousands)						
Net interest income from external sources	$6,749	$ —	$6,749	$5,646	$ —	$5,646
Other income from external sources	730	1,747	2,477	786	1,738	2,524
Depreciation and amortization	266	6	272	252	6	258
Income before income taxes	2,022	820	2,842	1,514	835	2,349
Income tax expense (1)	503	328	831	441	334	775
Total assets	865,832	6,450	872,282	709,893	6,879	716,772

(1) Insurance Services calculated at statutory tax rate of 40% .

NOTE 8 – STOCK-BASED COMPENSATION

We currently have stock-based compensation plans in place for our directors, officers, employees, consultants and advisors. Under the terms of these plans we may grant restricted shares and stock options for the purchase of our common stock. The stock-based compensation is granted under terms determined by our Compensation Committee. Our standard stock option grants have a maximum term of 10 years, generally vest over periods ranging between one and five years, and are granted with an exercise price equal to the fair market value of the common stock on the date of grant. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests over periods of three to five years. All dividends paid on restricted stock, whether vested or unvested, are paid to the shareholder.

Information regarding our stock option plans for the three months ended March 31, 2017 is as follows:

	Number of Shares	Weighted Average Exercise Price per Share	Weighted Average Contractual Term	Aggregate Intrinsic Value
Options outstanding, beginning of year	69,123	$ 11.10		
Options outstanding, end of quarter	69,123	$ 11.10	8.1	$361,591
Options exercisable, end of quarter	22,405	$ 10.69	8.0	$53,964
Option price range at end of quarter	$9.97 to $12.83			
Option price of exercisable shares	$9.97 to $12.83			

The following table summarizes information about stock option assumptions:

	2016	
Expected dividend yield	1.25	%

Expected volatility	22.72	%
Risk-free interest rate	1.71	%
Expected option life	7.5 years	

During the three months ended March 31, 2017 and 2016, we expensed $12 thousand and $11 thousand, respectively, in stock-based compensation under stock option awards.

There were no options granted during the three months ended March 31, 2017. The weighted average grant date fair values of options granted during the three months ended March 31, 2016, were $3.37 per share. Expected future expense relating to the unvested options outstanding as of March 31, 2017 is $153 thousand over a weighted average period of 3.1 years. Upon exercise of vested options, management expects to draw on treasury stock as the source of the shares.

The summary of changes in unvested restricted stock awards for the three months ended March 31, 2017, is as follows:

	Number of Shares		Weighted Average Grant Date Fair Value
Unvested restricted stock, beginning of year	80,743		$10.51
Granted	47,326		21.59
Forfeited	(3,235	)	11.27
Vested	(36,339D,"background-color:#E5E5E5;" -->		

2/2/2016 60,700 78.620 2/2/2026

159,909 13,817,737

(1) All options shown in the table have a maximum term for exercise of ten years from the grant date. Under certain circumstances, the terms for exercise may be shorter, and in certain circumstances, the options may be forfeited and cancelled. All awards shown in the table have associated restrictions upon transferability.

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EXECUTIVE COMPENSATION TABLES

(2)
The dates presented in this column represent the respective dates on which the awards were granted by ConocoPhillips for grants prior to the spin-off from ConocoPhillips, and by Phillips 66 for all other awards. The awards granted prior to the spin-off were converted to Phillips 66 equity awards in connection with the spin-off and in accordance with the Employee Matters Agreement and remain subject to the same general terms and conditions.

(3)
The options shown in this column vested and became exercisable in 2016 or prior years (although under certain termination circumstances, the options may still be forfeited). Options become exercisable in one-third increments on the first, second and third anniversaries of the grant date.

(4)
These amounts include unvested restricted stock and RSUs awarded under the PSP for performance periods ending on or before December 31, 2014 and awarded as annual awards. All awards for performance periods ending on or before December 31, 2014 continue to have restrictions upon transferability. Restrictions on PSP awards for performance periods ending on or before December 31, 2010 lapse upon separation from service. Restrictions on PSP awards for later performance periods lapse five years from the grant date unless the NEO elected prior to the beginning of the performance period to defer lapsing of the restrictions until separation from service. Awards are subject to forfeiture if, prior to lapsing, the NEO separates from service for a reason other than death, disability, layoff, retirement after reaching age 55 with five years of service, or after a change of control, although the Compensation Committee has the authority to waive forfeiture. The awards have no voting rights, but do entitle the holder to receive dividend equivalents in cash. The value of the awards reflects the closing price of our stock, as reported on the NYSE, on December 30, 2016 ($86.410).

(5)
Reflects potential awards from ongoing performance periods under the PSP for performance periods ending December 31, 2017 and December 31, 2018. These awards are shown at maximum levels; however, there is no assurance that awards will be granted at, below or above target after the end of the relevant performance periods, as the determination to make a grant and the amount of any grant is within the judgment of the Compensation Committee. Until an actual grant is made, these unearned awards pay no dividend equivalents. The value of these unearned awards reflects the closing price of our stock, as reported on the NYSE, on December 30, 2016 ($86.410).

OPTION EXERCISES AND STOCK VESTED FOR 2016

The following table summarizes the value received from stock option exercises and stock grants vested during 2016:

	OPTION AWARDS		STOCK AWARDS(1)	
NAME	**NUMBER OF SHARES ACQUIRED ON**	**VALUE REALIZED UPON EXERCISE ($)**	**NUMBER OF SHARES ACQUIRED ON**	**VALUE REALIZED UPON VESTING ($)**

	EXERCISE (#)		VESTING (#)	
Greg Garland	138,665	6,922,898	191,969	16,337,483
Robert Herman	82,699	4,632,707	24,870	2,133,017
Paula Johnson	40,141	1,921,155	30,952	2,656,808
Kevin Mitchell			12,145	1,055,106
Tim Taylor	77,260	3,685,473	61,234	5,239,514

(1)
Stock awards include restricted stock units that vested during the year, as well as the PSP 2014-2016 award that vested on December 31, 2016, and was paid out in cash in early 2017. The PSP awards were as follows: Mr. Garland 147,788 units valued at $12,839,189; Mr. Herman 21,296 units valued at $1,850,105; Ms. Johnson 26,761 units valued at $2,324,881; Mr. Mitchell 12,145 units valued at $1,055,106; and Mr. Taylor 50,828 units valued at $4,415,719.

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EXECUTIVE COMPENSATION TABLES

PENSION BENEFITS AS OF DECEMBER 31, 2016

Our defined benefit pension plan covering NEOs, the Phillips 66 Retirement Plan, consists of multiple titles with different terms. NEOs are only eligible to participate in one title at any time, but may have frozen benefits under one or more other titles.

	TITLE I	**TITLE II(1)**	**TITLE IV**
Current Eligibility	Mr. Garland	Mr. Taylor, Mr. Mitchell, Mr. Herman(4)	Ms. Johnson
Normal Retirement	Age 65	Age 65	Age 65
Early Retirement(2)	Age 55 with five years of service or if laid off during or after the year in which the participant reaches age 50	Executives may receive their vested benefit upon termination of employment at any age	Age 50 with ten years of service
Benefit Calculation(2)	Calculated as the product of 1.6 percent times years of credited service multiplied by the final average eligible earnings	Based on monthly pay and interest credits to a nominal cash balance account created on the first day of the month after an executive's hire date. Pay credits are equal to a percentage of total salary and annual bonus.	Calculated as the product of 1.6 percent times years of credited service multiplied by the final average eligible earnings
Final Average Earnings Calculation	Calculated using the three highest consecutive compensation years in the last ten calendar years before retirement plus the year of retirement	N/A	Calculated using the higher of the highest three years of compensation or the highest consecutive 36 months of compensation
Eligible Pension Compensation(3)	Includes salary and annual bonus	Includes salary and annual bonus	Includes salary and annual bonus
Benefit Vesting	All participants are vested in this title	Employees vest after three years of service	All participants are vested in this title
Payment Types	Allows payments in the form of several annuity types or a single lump sum		
IRS limitations	Benefits under all Titles are limited by the IRC. In 2016, that limit was $265,000. The IRC also limits the annual benefit available under these Titles expressed as an annuity. In 2016, that limit was $210,000 (reduced actuarially for ages below 62).		

(1)

NEOs whose combined years of age and service total less than 44 receive a six percent pay credit, those with 44 through 65 receive a seven percent pay credit and those with 66 or more receive a nine percent pay credit. Interest credits are applied to the cash balance account each month. This credit is calculated by multiplying the value of the account by the interest credit rate, based on 30-year U.S. Treasury security rates adjusted quarterly.

(2)

An early benefit reduction is calculated on Title I by reducing the benefit 5% for each year before age 60 that benefits are paid. An early benefit reduction is calculated on Title III by reducing the benefit 6.67% for each year before age 60 that benefits are paid, unless the participant has at least 85 points awarded, with one point for each year of age and one point for each year of service. Title IV early benefit reduction is calculated by reducing the benefit by 5% per year for each year before age 57 that benefits are paid and 4% per year for benefits that are paid between ages 57 and 60. The benefit calculation for Titles I, III and IV is reduced by the product of 1.5% of the annual primary social security benefit multiplied by years of credited service, although a reduction limit of 50% of the primary Social Security benefit may apply.

(3)

Under Title I, if an executive receives layoff benefits, then the eligible compensation calculation also includes the annualized salary for the year of layoff (rather than the actual salary for that year) and years of service are increased by any period for which layoff benefits are calculated.

(4)

Mr. Herman has a frozen benefit under Title III from prior years of service with predecessor companies.

EXECUTIVE COMPENSATION TABLES

The following table lists the pension program participation and actuarial present value of each NEO's defined benefit pension as of December 31, 2016.

NAME	PLAN NAME	NUMBER OF YEARS CREDITED SERVICE (#)(1)	PRESENT VALUE OF ACCUMULATED BENEFIT ($)	PAYMENTS DURING LAST FISCAL YEAR ($)
Greg Garland	Phillips 66 Retirement Plan Title I	27	1,519,964	
	Phillips 66 Key Employee Supplemental Retirement Plan(2)		31,478,484	
Robert Herman	Phillips 66 Retirement Plan Title II	11	292,695	
	Phillips 66 Retirement Plan Title III	22	504,246	
	Phillips 66 Key Employee Supplemental Retirement Plan(2)		602,677	
Paula Johnson	Phillips 66 Retirement Plan Title IV	14	579,488	
	Phillips 66 Key Employee Supplemental Retirement Plan(2)		2,790,449	
Kevin Mitchell	Phillips 66 Retirement Plan Title II	3	57,497	
	Phillips 66 Key Employee Supplemental Retirement Plan(2)		100,154	
Tim Taylor	Phillips 66 Retirement Plan Title II	5	120,733	
	Phillips 66 Key Employee Supplemental Retirement Plan(2)		811,150	

(1) Years of credited service include service recognized under the predecessor ConocoPhillips plans from which these plans were spun off effective May 1, 2012.

(2) The Phillips 66 Key Employee Supplemental Retirement Plan restores Company-sponsored benefits capped under the qualified defined benefit pension plan due to IRC limits. All employees, including our NEOs, are eligible to participate in the plan.

NONQUALIFIED DEFERRED COMPENSATION

Our NEOs are eligible to participate in two nonqualified deferred compensation plans, the Phillips 66 KEDCP and the Phillips 66 DCMP.

The KEDCP allows NEOs to defer up to 50 percent of their salary and up to 100 percent of their VCIP. The default distribution option is a lump sum payment paid at least six months after separation from service. NEOs may elect to defer payments from one to five years, and to receive annual, semiannual or quarterly payments for a period of up to fifteen years. NEOs may also elect to defer their VCIP to a specific date in the future.

The DCMP is a nonqualified restoration plan for employer contributions that cannot be made to our 401(k) plan either due to an NEO's salary deferral under the KEDCP or due to the IRC annual limit on compensation that may be taken into account under a qualified plan. Distributions are made as a lump sum six months after separation from service, unless the NEO elects to receive one to fifteen annual payments beginning at least one year after separation from service.

Each NEO directs investments of his or her individual accounts under the KEDCP and DCMP. Both plans provide a broad range of market-based investments that may be changed daily. No investment provides above-market returns. The aggregate performance of these investments is reflected in the **Nonqualified Deferred Compensation** table below.

Benefits due under these plans are paid from our general assets, although we also maintain rabbi trusts that may be used to pay benefits. The trusts and the funds held in them are Company assets. In the event of our bankruptcy, NEOs would be unsecured general creditors.

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EXECUTIVE COMPENSATION TABLES

The following table provides information on nonqualified deferred compensation as of December 31, 2016:

ME	APPLICABLE PLAN(1)	BEGINNING BALANCE ($)	EXECUTIVE CONTRIBUTIONS IN LAST FISCAL YEAR ($)	COMPANY CONTRIBUTIONS IN THE LAST FISCAL YEAR ($)(2)	AGGREGATE EARNINGS IN LAST FISCAL YEAR ($)(3)	AGGREGATE WITHDRAWALS/ DISTRIBUTIONS ($)	AGGREGA BALAN AT LA FISC YEAR E ($
g and	Phillips 66 Defined Contribution Make-Up Plan	828,332		94,627	70,046		993
	Phillips 66 Key Employee Deferred Compensation Plan	1,033,274			69,508		1,102
ert nan	Phillips 66 Defined Contribution Make-Up Plan	258,736		27,763	23,649		310
	Phillips 66 Key Employee Deferred Compensation Plan	1,601,531			187,988		1,789
a son	Phillips 66 Defined Contribution Make-Up Plan	149,008		30,378	13,973		193
	Phillips 66 Key Employee Deferred Compensation Plan						
n hell	Phillips 66 Defined Contribution Make-Up Plan	19,100		29,641	1,398		50
	Phillips 66 Key Employee Deferred Compensation Plan						
		392,188		56,446	26,598		475

or	Phillips 66 Defined Contribution Make-Up Plan			
	Phillips 66 Key Employee Deferred Compensation Plan	1,706,469	138,802	1,845

(1) We have two defined contribution deferred compensation programs for our executives the DCMP and the KEDCP. As of December 31, 2016, participants in these plans had 92 investment options 27 of the options were the same as those available in our 401(k) plan and the remaining options were other mutual funds approved by the plan administrator.

(2) These amounts represent Company contributions under the DCMP. These amounts are also included in the "All Other Compensation" column of the **Summary Compensation Table**.

(3) These amounts represent earnings on plan balances from January 1 to December 31, 2016. These amounts are not included in the **Summary Compensation Table**.

(4) The total reflects contributions by our NEOs, contributions by us, and earnings on balances prior to 2016; plus contributions by our NEOs, and earnings from January 1, 2016 through December 31, 2016 (shown in the appropriate columns of this table, with amounts that are included in the **Summary Compensation Table**). The total includes all contributions by our NEOs and by us reported in this proxy statement and our proxy statements from prior years as follows: $620,525 for Mr. Garland; $27,763 for Mr. Herman; $150,028 for Ms. Johnson; $29,641 for Mr. Mitchell; and $305,444 for Mr. Taylor.

POTENTIAL PAYMENTS UPON TERMINATION OR CHANGE IN CONTROL

Each of our NEOs is expected to receive amounts earned during his or her period of employment unless he or she voluntarily resigns prior to becoming retirement-eligible or is terminated for cause. Although normal retirement age under our benefit plans is 65, early retirement provisions allow receipt of benefits at earlier ages if vesting requirements are met. For our incentive compensation programs (VCIP, RSU, Stock Options, and PSP), early retirement is generally defined as termination at or after the age of 55 with five years of service.

As of December 31, 2016, Mr. Garland, Mr. Herman, and Mr. Taylor were retirement-eligible under both our benefit plans and our compensation programs. Therefore, as of December 31, 2016, a voluntary resignation of Mr. Garland, Mr. Herman, or Mr. Taylor, would have been treated as a retirement, and each would have retained all awards earned under the current and earlier programs. As such, awards under these programs are not included in the amounts reflected in the table below. Please see the **Outstanding Equity Awards at Fiscal Year End** table for more information. Our compensation programs provide for the following upon retirement:

Cash Payments

VCIP earned during the fiscal year

Amounts contributed and vested under our defined contribution plans

Amounts accrued and vested under our pension plans

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EXECUTIVE COMPENSATION TABLES

Equity

- Grants under the PSP for ongoing performance periods in which the executive participated for at least one year
- Previously granted restricted stock and RSUs
- Previously granted stock option awards exercisable through the original term

The table at the end of this section summarizes the potential additional value of the benefits to be received by each NEO as of December 31, 2016, through the Phillips 66 ESP due to an involuntary termination without cause or through the Phillips 66 CICSP due to a change in control event. Benefits that would be available generally to all or substantially all salaried employees on the U.S. payroll are not included in the amounts shown. Executives are not entitled to receive benefits under both the ESP and the CICSP as a result of the same event. These two plans have the following in common:

- Amounts payable under both are offset by any payments or benefits payable under any of our other plans.
- Benefits under both may also be reduced in the event of willful and bad faith conduct demonstrably injurious to the Company.
- Both are Company plans under which awards and payments are subject to clawback provisions and to forfeiture or recoupment, in whole or in part, under applicable law, including the Sarbanes-Oxley Act and the Dodd-Frank Act.

Executive Severance Plan

The ESP provides that if an NEO separates due to an involuntary termination without cause, the executive will receive the following benefits, which may vary depending on salary grade level:

Cash Severance Payments

- A lump sum payment equal to one and one-half or two times the sum of the executive's base salary and current target annual bonus.
- A lump sum payment equal to the present value of the increase in pension benefits that would result from crediting the executive with an additional one and one-half or two years of age and service under the pension plan.
- A lump sum payment generally equal to the Company contribution for active employees toward the cost of certain welfare benefits for an additional one and one-half or two years.

Accelerated Equity

Layoff treatment under our compensation plans generally allows the executive to retain a prorated portion of grants held less than one year and full grants held for one year or more of Restricted Stock, RSUs, and Stock Options, and maintain eligibility for PSP awards for ongoing periods in which he or she had participated for at least one year.

Change in Control Severance Plan

The CICSP provides that if, within two years of a change in control of the Company, an executive's employment is terminated by the employer other than for cause, or by the executive for good reason, the executive will receive the following benefits, which may vary depending on salary grade level:

Cash Severance Payments

A lump sum payment equal to two or three times the sum of the executive's base salary and the higher of the current target annual bonus or the average of the annual bonuses paid for the previous two years.

A lump sum payment equal to the present value of the increase in pension benefits that would result from crediting the executive with an additional two or three years of age and service under the pension plan.

A lump sum payment generally equal to the Company contribution for active employees toward the cost of certain welfare benefits for an additional two or three years.

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EXECUTIVE COMPENSATION TABLES

Accelerated Equity

Vesting of all equity awards and lapsing of any restrictions.

Death or Disability

For completeness, payments that would be payable to each NEO upon separation as a result of disability or to each NEO's estate as a result of death are likewise provided.

EXECUTIVE BENEFITS AND PAYMENTS UPON TERMINATION

	INVOLUNTARY NOT-FOR-CAUSE TERMINATION (NOT CIC) ($)	INVOLUNTARY OR GOOD REASON TERMINATION (CIC) ($)	DEATH ($)	DISABILITY ($)
Greg Garland				
Severance Payment	12,893,437	21,603,684		
Accelerated Equity(1)				
Life Insurance			3,250,032	
TOTAL	12,893,437	21,603,684	3,250,032	
Robert Herman				
Severance Payment	2,728,237	4,567,647		
Accelerated Equity(1)				
Life Insurance			1,340,016	
TOTAL	2,728,237	4,567,647	1,340,016	
Paula Johnson				
Severance Payment	3,425,403	5,799,676		
Accelerated Equity(1)	11,334,547	11,334,547	11,334,547	11,334,547
Life Insurance			1,409,136	
TOTAL	14,759,950	17,134,223	12,743,683	11,334,547
Kevin Mitchell				
Severance Payment	2,825,209	4,237,814		
Accelerated Equity(1)	7,317,346	7,317,346	7,317,346	7,317,346
Life Insurance			1,384,272	

TOTAL	10,142,555	11,555,160	8,701,618	7,317,346
Tim Taylor				
Severance Payment	4,977,446	8,793,938		
Accelerated Equity(1)				
Life Insurance			2,161,536	
TOTAL	4,977,446	8,793,938	2,161,536	

(1)

For the PSP, amounts for PSP 2014-2016 are shown based on the cash amount received in February 2017, while amounts for other periods are prorated to reflect the portion of the performance period completed by the end of 2016 and shown at target payout levels. These amounts reflect the closing price of our stock as reported on the NYSE on December 30, 2016 ($86.41).

Restricted Stock and RSU amounts reflect the closing price of our stock as reported on the NYSE on December 30, 2016 ($86.41).

For Stock Options with an exercise price lower than our stock's closing price on December 31, 2016, amounts reflect the intrinsic value as if the options had been exercised on December 31, 2016, but only for options the NEO would have retained for the specific termination event.

NON-EMPLOYEE DIRECTOR COMPENSATION

The primary elements of our non-employee Director compensation program are equity compensation and cash compensation, the current levels of which have been in place since January 1, 2016.

OBJECTIVES AND PRINCIPLES

Compensation for non-employee Directors is reviewed annually by the Nominating Committee, with the assistance of such third-party consultants as the Nominating Committee deems advisable, and set by action of the Board of Directors. The Board's goal in designing such compensation is to provide a competitive package that will enable it to attract and retain highly skilled individuals with relevant experience and reflects the time and talent required to serve on the board of a complex, multinational corporation. The Board seeks to provide sufficient flexibility in the form of payment to meet individual needs while ensuring that a substantial portion of director compensation is linked to the long-term success of the Company. In furtherance of our commitment to be a socially responsible member of the communities in which we participate, the Board believes that it is appropriate to extend the Phillips 66 matching gift program to charitable contributions made by individual Directors.

Equity Compensation

In 2016, each non-employee Director received a grant of RSUs with an aggregate value of $200,000 on the date of grant. Restrictions on the units issued to a non-employee Director will lapse in the event of retirement, disability, death, or a change of control, unless the Director has elected to receive the underlying shares after a stated period of time. Directors forfeit the units if, prior to the lapse of restrictions, the Board finds sufficient cause for forfeiture (although no such finding can be made after a change in control). Before the restrictions lapse, Directors cannot sell or otherwise transfer the units, but the units are credited with dividend equivalents in the form of additional RSUs. When restrictions lapse, Directors will receive unrestricted shares of Company stock as settlement of the RSUs.

Cash Compensation

In 2016, each non-employee Director received $125,000 in cash compensation for service as a Director. Non-employee Directors serving in specified committee or leadership positions also received the following additional cash compensation:

	LEAD / CHAIR	MEMBER
Lead Director	$ 50,000	N/A
Audit and Finance Committee	$ 25,000	$ 10,000
Human Resources and Compensation Committee	$ 25,000	$ 10,000
All Other Committees	$ 10,000	N/A

The total annual cash compensation is payable in monthly cash installments. Directors may elect, on an annual basis, to receive all or part of their cash compensation in unrestricted stock or in RSUs (such unrestricted stock or RSUs are issued on the last business day of the month valued using the average of the high and low prices of Phillips 66 common stock as reported on the NYSE on such date), or to have the amount credited to the Director's deferred compensation account as described below. The RSUs issued in lieu of cash compensation are subject to the same restrictions as the annual RSUs described above under **Equity Compensation**.

Deferral of Compensation

Non-employee Directors can elect to defer their cash compensation under the Phillips 66 Deferred Compensation Program for non-Employee Directors (the "Director Deferral Plan"). Deferred amounts are deemed to be invested in various mutual funds and similar investment choices (including Phillips 66 common stock) selected by the Director from a list of investment choices available under the Director Deferral Plan.

The future payment of any compensation deferred by non-employee Directors of Phillips 66 may be funded in a grantor trust designed for this purpose.

Directors' Matching Gift Program

All active and retired non-employee Directors are eligible to participate in the Directors' Annual Matching Gift Program. This provides a dollar-for-dollar match of gifts of cash or securities, up to a maximum during any one calendar year of $15,000 per donor for active Directors and $7,500 per donor for retired Directors, to charities and educational institutions (excluding certain religious, political, fraternal, or collegiate athletic organizations) that are tax-exempt under Section 501(c)(3) of the IRC or meet similar requirements under the applicable law of other countries. Amounts representing these matching contributions are contained in the "All Other Compensation" column of the **Non-employee Director Compensation Table**.

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NON-EMPLOYEE DIRECTOR COMPENSATION

Other Compensation

The Board believes that it is important for spouses or significant others of Directors and executives to attend certain meetings to enhance the collegiality of the Board. The cost of such attendance is treated by the Internal Revenue Service as income and is taxable to the recipient. The Company reimburses Directors for the cost of resulting income taxes. Amounts representing this reimbursement are contained in the "All Other Compensation" column of the **Non-employee Director Compensation Table**.

Stock Ownership

Each Director is expected to own an amount of Company stock equal to at least the aggregate amount of the annual equity grants during their first five years on the Board. Directors are expected to reach this level of target ownership within five years of joining the Board. Actual shares of stock, Restricted Stock, or RSUs, including deferred stock units, may be counted in satisfying the stock ownership guidelines. All current directors are in compliance, or on pace to comply, with the guidelines.

NON-EMPLOYEE DIRECTOR COMPENSATION TABLE

Phillips 66 benchmarks its non-employee Director compensation design and pay levels against a group of peer companies. The Company targets the median of this peer group for all elements of non-employee Director compensation.

The following table summarizes the compensation for our non-employee Directors for 2016 (for compensation paid to our sole employee Director, Mr. Garland, please see **Executive Compensation Tables**):

NAME	FEES EARNED OR PAID IN CASH ($)(1)	STOCK AWARDS ($)(2)	OPTION AWARDS ($)	NON-EQUITY INCENTIVE PLAN COMPENSATION ($)	CHANGE IN PENSION VALUE AND NONQUALIFIED DEFERRED COMPENSATION EARNINGS ($)	ALL OTHER COMPENSATION ($)(3)	TOTAL ($)
Gary K. Adams	31,935	47,331				2,715	81,981
J. Brian Ferguson	150,000	200,066				2,790	352,856
William R. Loomis, Jr.	148,750	200,066				23,748	372,564
John E. Lowe	137,500	200,066				9,136	346,702
Harold W. McGraw III	146,667	200,066				523	347,256
Denise L. Ramos	31,935	47,331				362	79,628
Glenn F. Tilton	180,833	200,066				17,632	398,531
Victoria J. Tschinkel	142,500	200,066				17,857	360,423
Marna C.	138,750	200,066				21,826	360,642

Whittington

(1)

Reflects 2016 base cash compensation of $125,000 payable to each non-employee Director. In 2016, non-employee Directors serving in specified committee positions also received the additional cash compensation described previously. Compensation amounts reflect adjustments related to various changes in committee assignments by Board members throughout the year, if any. Amounts shown include any amounts that were voluntarily deferred to the Director Deferral Plan, received in Phillips 66 common stock, or received in RSUs.

(2)

Amounts represent the grant date fair market value of RSUs. Under our non-employee Director compensation program, non-employee Directors received a 2016 grant of RSUs with an aggregate value of $200,000 on the date of grant, based on the average of the high and low prices for Phillips 66 common stock, as reported on the NYSE, on such date. These grants are made in whole shares with fractional share amounts rounded up, resulting in shares with a value of $200,066 being granted on January 15, 2016. The grants to Mr. Adams and Ms. Ramos are pro rated amounts reflecting that they joined the Board in October 2016.

(3)

All Other Compensation is made up primarily of certain gifts by Directors to charities and educational institutions (excluding certain religious, political, fraternal, or athletic organizations) that are tax-exempt under Section 501(c)(3) of the IRC or meet similar requirements under the applicable law of other countries that we match under our Matching Gifts Program (Mr. Loomis $15,000; Mr. Lowe $6,000; Mr. Tilton $15,000; Ms. Tschinkel $15,000, and Ms. Whittington $15,000). For active Directors, the program matches up to $15,000 with regard to each program year. The amounts shown reflect the actual payments made by us in 2016. All Other Compensation also includes any personal flights, automobile transportation expenses, smaller gifts (such as books, ornaments, and jackets) as well as associated tax protection, and tax assistance when we request family members or other guests to accompany a Director to a Company function and, as a result, the Director is deemed to make personal use of Company assets such as Company aircraft and thereby incurs imputed income.

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EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth information about Phillips 66 common stock that may be issued under all existing equity compensation plans as of December 31, 2016:

PLAN CATEGORY	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS(1,2) (a)	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS(3) (b)	NUMBER OF SECURITIES REMAINING AVAILABLE FOR FUTURE ISSUANCE UNDER EQUITY COMPENSATION PLANS (EXCLUDING SECURITIES REFLECTED IN COLUMN (a))(4) (c)
Equity compensation plans approved by security holders	11,619,005	49.48	38,196,937
Equity compensation plans not approved by security holders	0	0	
Total	11,619,005	49.48	38,196,937

(1)
Includes awards issued under the Omnibus Stock and Performance Incentive Plan of Phillips 66 and awards issued under the 2013 Omnibus Stock and Performance Incentive Plan of Phillips 66.

(2)
Includes an aggregate of 5,103,130 Incentive Stock Options and Nonqualified Stock Options issued to employees, 20,640 Restricted Stock Awards granted under historical LTI plans, and 3,239,497 PSUs. The number of securities to be issued includes 3,255,738 RSUs, of which 226,995 were issued to non-employee Directors. Some awards held by ConocoPhillips employees at our spin-off were adjusted or substituted with a combination of ConocoPhillips and Phillips 66 equity. Awards representing a total of 13,071,435 shares were issued to ConocoPhillips employees, of which 3,429,061 remain outstanding as of December 31, 2016. The awards issued to ConocoPhillips employees are included in the outstanding awards listed above.

(3)
The weighted-average exercise price reflects the weighted-average price for outstanding Incentive Stock Options and Nonqualified Stock Options only. It does not include stock awards outstanding.

(4)
Total includes forfeited shares under the Omnibus Stock and Performance Incentive Plan of Phillips 66 that are now available for grant under the 2013 Omnibus Stock and Performance Incentive Plan of Phillips 66.

STOCK OWNERSHIP

Holdings of Major Shareholders

The following table sets forth information regarding persons who we know to be the beneficial owners of more than five percent of our issued and outstanding common stock (as of the date of such shareholder's most recent ownership filing with the SEC):

	COMMON STOCK	
NAME AND ADDRESS	NUMBER OF SHARES	PERCENT OF CLASS
Berkshire Hathaway Inc.(1) 3555 Farnam Street Omaha, Nebraska 68131	80,689,892	15.55%
The Vanguard Group(2) 100 Vanguard Blvd. Malvern, PA 19335	30,915,033	5.96%
BlackRock, Inc.(3) 55 East 52nd Street New York, NY 10055	27,862,379	5.36%

(1) Based solely on an Amendment to Schedule 13G filed with the SEC on February 14, 2017, by Warren E. Buffett on behalf of himself and Berkshire Hathaway Inc., National Indemnity Company, National Liability & Fire Insurance Co., Berkshire Hathaway Assurance Corp., Columbia Insurance Company, Flightsafety International Inc. Retirement Income Plan, Fruit of the Loom Pension Trust, GEICO Corporation Pension Plan Trust, Johns Manville Corporation Master Pension Trust, and General Re Corp. Employee Retirement Trust.

(2) Based solely on an Amendment to Schedule 13G filed with the SEC on February 13, 2017, by The Vanguard Group on behalf of itself, Vanguard Fiduciary Trust Company, and Vanguard Investments Australia, Ltd.

(3) Based solely on an Amendment to Schedule 13G filed with the SEC on January 25, 2017, by BlackRock, Inc. on behalf of itself, BlackRock Advisors, LLC, BlackRock Financial Management, Inc., BlackRock Investment Management, LLC, BlackRock Investment Management (Australia) Limited, BlackRock Investment Management (UK) Ltd, BlackRock (Luxembourg) S.A., BlackRock (Netherlands) B.V., BlackRock Fund Managers Ltd, BlackRock Life Limited, BlackRock Asset Management Canada Limited, BlackRock Asset Management Ireland Limited, BlackRock Asset Management Schweiz AG, BlackRock (Singapore) Limited, BlackRock Advisors (UK) Limited, BlackRock Fund Advisors, BlackRock International Limited, BlackRock Institutional Trust Company, N.A., BlackRock Japan Co. Ltd., BlackRock Asset Management North Asia Limited, and FutureAdvisor, Inc.

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STOCK OWNERSHIP

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires directors and executive officers of Phillips 66, and persons who own more than 10 percent of a registered class of Phillips 66 equity securities, to file reports of ownership and changes in ownership of Phillips 66 common stock with the SEC and the NYSE, and to furnish Phillips 66 with copies of the forms they file. To our knowledge, based solely upon a review of the copies of such reports furnished to the Company and written representations of our officers and directors, during the year ended December 31, 2016, all Section 16(a) reports applicable to those officers and directors were filed on a timely basis, except for the following: (1) a Form 4 that was filed on March 7, 2016, on behalf of Chukwuemka Oyolu, Vice President and Controller, related to a sale by his spouse on February 29, which was delayed while awaiting information from the executing broker; (2) a Form 4 that was filed on September 22, 2016, on behalf of Robert Herman, Executive Vice President, Midstream, related to a sale on September 15, which was delayed while awaiting information from the executing broker; and (3) a Form 4 that was filed on January 12, 2017, on behalf of Greg Garland, Chairman and CEO, related to Phillips 66 stock held by his late father's estate; Mr. Garland became the executor of the estate on September 26, 2016, and discovered that his father owned the stock subsequent to the filing of a Form 4 on behalf of Mr. Garland in November 2016.

SECURITIES OWNERSHIP OF OFFICERS AND DIRECTORS

The following table sets forth the number of shares of our common stock beneficially owned as of March 10, 2017, by each Phillips 66 Director, by each NEO and by all of our directors and executive officers as a group. Together these individuals beneficially own less than one percent of our common stock. The table also includes information about stock options, restricted stock, RSUs and Deferred Stock Units credited to the accounts of our directors and executive officers under various compensation and benefit plans. For purposes of this table, shares are considered to be "beneficially" owned if the person, directly or indirectly, has sole or shared voting or investment power with respect to such shares. In addition, a person is deemed to beneficially own shares if that person has the right to acquire such shares within 60 days of March 10, 2017.

	NUMBER OF SHARES OR UNITS		
NAME OF BENEFICIAL OWNER	**TOTAL COMMON STOCK BENEFICIALLY OWNED**	**RESTRICTED/DEFERRED STOCK UNITS(1)**	**OPTIONS EXERCISABLE WITHIN 60 DAYS(2)**
Mr. Garland	126,963	610,837	481,794
Ms. Johnson	26,789	80,541	59,266
Mr. Mitchell	5,972	62,688	16,866
Mr. Taylor	48,709	166,028	117,299
Mr. Herman	16,219	79,794	96,399
Mr. Adams	2,978		
Mr. Ferguson	234	18,134	
Mr. Loomis	72,582	20,038	
Mr. Lowe	30,000	18,134	
Mr. McGraw(3)	873	36,802	
Ms. Ramos		2,982	
Mr. Tilton	5,900	18,134	
Ms. Tschinkel(4)	40,253	10,505	
Dr. Whittington	2,500	18,134	
Directors and Executive Officers as a Group (16 Persons)	408,683	1,326,485	862,356

(1) Includes RSUs or Deferred Stock Units that may be voted or sold only upon passage of time.

(2) Includes beneficial ownership of shares of common stock which may be acquired within 60 days of March 10, 2017, through stock options awarded under compensation plans.

(3) Includes 373 shares held on behalf of the Harold W. McGraw Family Foundation, Inc., of which Mr. McGraw serves on the board, or various trusts for the benefit of various family members of Mr. McGraw and for which trusts Mr. McGraw serves as trustee and has voting and investment power. Mr. McGraw disclaims beneficial ownership of all securities held by the foundation and the trusts.

(4) Includes 171 shares of common stock owned by the Erika Tschinkel Trust.

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ABOUT THE ANNUAL MEETING

Who is soliciting my vote?

The Board of Directors of Phillips 66 is soliciting proxies to be voted at the 2017 Annual Meeting of Shareholders of Phillips 66.

Who is entitled to vote?

You may vote if you were the record owner of Phillips 66 common stock as of the close of business on March 10, 2017, the record date established by the Board of Directors. Each share of common stock is entitled to one vote. As of March 10, 2017, we had 516,970,525 shares of common stock outstanding and entitled to vote. There is no cumulative voting.

How many shares must be present to hold the meeting?

In order for us to hold our meeting, holders of a majority of our outstanding shares of common stock as of March 10, 2017, must be present in person or by proxy at the meeting. This is referred to as a quorum. Your shares are counted as present at the Annual Meeting if you attend the meeting and vote in person or if you properly return a proxy by Internet, telephone or mail. Abstentions and broker non-votes will also be counted for purposes of establishing a quorum at the meeting.

What is a broker non-vote?

Applicable rules permit brokers to vote shares held for the benefit of their clients on routine matters when the brokers have not received voting instructions from the beneficial owner on how to vote those shares. The ratification of an independent auditor is an example of a routine matter on which brokers may vote in this manner. Brokers may not vote shares held for the benefit of their clients on non-routine matters, such as the election of directors, proposals relating to executive compensation and proposals to amend certificates of incorporation and certain other corporate governance changes, unless they have received voting instructions from the beneficial owner on how to vote those shares. Shares that are not voted by brokers on non-routine matters are called broker non-votes.

How many votes are needed to approve each of the proposals?

Each of the director nominees requires the affirmative "**FOR**" vote of the majority of the votes cast in person or by proxy at the meeting. All other proposals require the affirmative "**FOR**" vote of a majority of those shares present in person or represented by proxy at the meeting and entitled to vote.

How do I vote?

You can vote either *in person* at the meeting or *by proxy*.

This proxy statement, the accompanying proxy card and the Company's 2016 Annual Report to Shareholders are being made available to the Company's shareholders on the Internet at *www.proxyvote.com* through the notice and access process. The Company's 2016 Annual Report to Shareholders contains consolidated financial statements and reports of the independent registered public accounting firm, management's discussion and analysis of financial condition and results of operations, information concerning the quarterly financial data for the past two fiscal years, and other information.

To vote by proxy, you must do one of the following:

Vote over the Internet (instructions are on the proxy card)

Vote by telephone (instructions are on the proxy card)

If you elected to receive a hard copy of your proxy materials, fill out the enclosed proxy card, date and sign it, and return it in the enclosed postage-paid envelope

If you hold your Phillips 66 stock in a brokerage account (that is, in "street name"), your ability to vote by telephone or over the Internet depends on your broker's voting process. Please follow the directions on your proxy card or voter instruction form carefully.

Even if you plan to attend the Annual Meeting, we encourage you to vote your shares by proxy. If you plan to vote in person at the Annual Meeting and you hold your Phillips 66 stock in street name, you must obtain a proxy from your broker and bring that proxy to the meeting.

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ABOUT THE ANNUAL MEETING

How do I vote if I hold my stock through a Phillips 66 employee benefit plan?

If you hold your stock through a Phillips 66 employee benefit plan, you must either:

- Vote over the Internet (instructions are in the email sent to you or on the notice and access form)
- Vote by telephone (instructions are on the notice and access form)
- If you elected to receive a hard copy of your proxy materials, fill out the enclosed voting instruction form, date and sign it, and return it in the enclosed postage-paid envelope

You will receive a separate voting instruction form for each employee benefit plan in which you hold Phillips 66 stock. Please pay close attention to the deadline for returning your voting instruction form to the plan trustee. The voting deadline for each plan is set forth on the voting instruction form. Please note that different plans may have different deadlines.

How can I revoke my proxy?

You can revoke your proxy by sending written notice of revocation of your proxy to our Corporate Secretary so that it is received prior to 5:00 p.m., Central Daylight Time, on May 2, 2017.

Can I change my vote?

Yes. You can change your vote at any time before the polls close at the Annual Meeting, which will void any earlier vote. You can change your vote by:

- Voting again by telephone or over the Internet prior to 11:59 p.m., Eastern Daylight Time, on May 2, 2017
- Signing another proxy card with a later date and returning it to us prior to the meeting
- Voting again at the meeting

If you hold your Phillips 66 stock in street name, you must contact your broker to obtain information regarding changing your voting instructions.

Who counts the votes?

We hired Broadridge Financial Solutions, Inc. to count the votes represented by proxies and cast by ballot, and appointed Jim Gaughan of Carl T. Hagberg and Associates to act as Inspector of Election.

Will my shares be voted if I don't provide my proxy and don't attend the Annual Meeting?

For shares held in your name, if you do not provide a proxy or vote your shares at the Annual Meeting, those shares will not be voted.

If you hold shares in street name, your broker may be able to vote those shares for certain "routine" matters even if you do not provide the broker with voting instructions. Only the ratification of Ernst & Young LLP as our independent registered public accounting firm for fiscal year 2017 is considered to be a routine matter.

If you do not give your broker instructions on how to vote your shares, the broker will return the proxy card without voting on proposals not considered "routine." This is a broker non-vote. Without instructions from you, the broker may not vote on any proposals other than the ratification of Ernst & Young LLP as our independent registered public accounting firm for 2017.

How are votes counted?

For all proposals, you may vote "**FOR**," "**AGAINST**," or "**ABSTAIN**." If you vote to "**ABSTAIN**" on the election of directors, it is not considered as a vote cast and, therefore, your vote will reduce the number, but not the percentage, of affirmative votes needed to elect the nominees. If you vote to "**ABSTAIN**" on the other proposals, your shares are still considered as present and entitled to vote and, therefore, your abstention has the same effect as a vote "**AGAINST**."

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ABOUT THE ANNUAL MEETING

What if I return my proxy but don't vote for some of the matters listed on my proxy card?

If you return a signed proxy card without indicating your vote, your shares will be voted "**FOR**" the director nominees listed on the card, "**FOR**" the ratification of Ernst & Young LLP as the independent registered public accounting firm for Phillips 66 for fiscal year 2017, and "**FOR**" the approval of the compensation of our Named Executive Officers.

Could other matters be decided at the Annual Meeting?

We are not aware of any other matters to be presented at the Annual Meeting. If any other matters are properly brought before the Annual Meeting, the persons named in your proxy will vote in accordance with their best judgment. Discretionary authority to vote on other matters is included in the proxy.

When will the Company announce the results of the vote?

Within four business days of the Annual Meeting, we will file a Current Report on Form 8-K announcing the results of the vote at the Annual Meeting.

Who can attend the Annual Meeting?

The Annual Meeting is open to all holders of Phillips 66 common stock. Each shareholder is permitted to bring one guest. No cameras, recording equipment, large bags, briefcases or packages will be permitted in the Annual Meeting, and security measures will be in effect to provide for the safety of attendees.

Do I need a ticket to attend the Annual Meeting?

Yes, you will need an admission ticket or proof of ownership of Phillips 66 stock to enter the meeting. If your shares are registered in your name, you will find an admission ticket attached to the proxy card sent to you. If your shares are held in the name of your broker or bank or you received your materials electronically, you will need to bring evidence of your stock ownership, such as your most recent brokerage statement. All shareholders will be required to present valid picture identification. **IF YOU DO NOT HAVE VALID PICTURE IDENTIFICATION AND EITHER AN ADMISSION TICKET OR PROOF THAT YOU OWN PHILLIPS 66 STOCK, YOU MAY NOT BE ADMITTED INTO THE MEETING**.

How can I access the Phillips 66 proxy materials and annual report electronically?

This proxy statement, the accompanying proxy card and the Company's 2016 Annual Report are being made available to the Company's shareholders on the Internet at *www.proxyvote.com* through the notice and access process. Most shareholders can elect to view future proxy statements and annual reports over the Internet instead of receiving paper copies in the mail.

If you own Phillips 66 stock in your name, you can choose this option, and help conserve resources and save the cost of producing and mailing these documents, by checking the box for electronic delivery on your proxy card or by following the instructions provided when you vote by telephone or over the Internet. If you hold your Phillips 66 stock through a bank, broker or other holder of record, please refer to the information provided by that entity for instructions on how to elect to view future proxy statements and annual reports over the Internet.

If you choose to view future proxy statements and annual reports over the Internet, you will receive a Notice of Internet Availability next year containing the Internet address to use to access our proxy statement and annual report. Your choice will remain in effect unless you change your election following the receipt of a Notice of Internet Availability. You do not have to elect Internet access each year. If you later change your mind and would like to receive paper copies of our proxy statements and annual reports, you can request both by phone at 800-579-1639, by email at *sendmaterial@proxyvote.com*, through the Internet at *www.proxyvote.com* or by writing to Phillips 66, c/o Broadridge Financial Solutions, Inc., 51 Mercedes Way, Edgewood, NY 11717. You will need your 12-digit control number located on your Notice of Internet

Availability to request a package. You will also be provided with the opportunity to receive a copy of the proxy statement and annual report in future mailings.

Will my vote be kept confidential?

The Board of Directors has a policy that shareholder proxies, ballots, and tabulations that identify shareholders are to be maintained in confidence. No such document will be available for examination, and the identity and vote of any shareholder will not be disclosed, except as necessary to meet legal requirements and allow the inspectors of election to certify the results of the shareholder vote. The policy also provides that inspectors of election must be independent and cannot be employees of the Company. Occasionally, shareholders provide written comments on their proxy card that may be forwarded to management.

What is the cost of this proxy solicitation?

The Board of Directors has sent you this proxy statement. Our directors, officers and employees may solicit proxies by mail, by email, by telephone or in person. Those persons will receive no additional compensation for any solicitation activities. We will request banking institutions, brokerage firms, custodians, trustees, nominees and fiduciaries to forward solicitation materials to the beneficial owners of common stock held of record by those entities, and we will, upon the request of those record holders, reimburse reasonable forwarding expenses. We will pay the costs of preparing, printing, assembling and mailing the proxy materials used in the solicitation of proxies. In addition, we have hired Alliance Advisors, LLC to assist us in soliciting proxies, which it may do by telephone or in person. We anticipate paying Alliance Advisors, LLC a fee of $15,000, plus expenses.

Why did my household receive a single set of proxy materials?

Securities and Exchange Commission (SEC) rules permit us to deliver a single copy of an annual report and proxy statement to any household not participating in electronic proxy material delivery at which two or more shareholders reside, if we believe the shareholders are members of the same family. This benefits both you and the Company, as it eliminates duplicate mailings that shareholders living at the same address receive and conserves resources and reduces printing and mailing costs. This rule applies to any annual reports, proxy statements, proxy statements combined with a prospectus or information statements. Each shareholder will continue to receive a separate proxy card or voting instruction card. Your household may have received a single set of proxy materials this year. If you prefer to receive your own copy now or in future years, please request a duplicate set by phone at 800-579-1639, through the Internet at *www.proxyvote.com*, by email at *sendmaterial@proxyvote.com*, or by writing to Phillips 66, c/o Broadridge Financial Solutions, Inc., 51 Mercedes Way, Edgewood, NY 11717. Shareholders sharing the same address can request delivery of a single copy of these materials using the same methods described in the preceding sentence. If a broker or other nominee holds your shares, you may continue to receive some duplicate mailings. Certain brokers will eliminate duplicate account mailings by allowing shareholders to consent to such elimination, or through implied consent if a shareholder does not request continuation of duplicate mailings. Because not all brokers and nominees may offer shareholders the opportunity to request eliminating duplicate mailings, you may need to contact your broker or nominee directly to discontinue duplicate mailings to your household.

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SUBMISSION OF FUTURE SHAREHOLDER PROPOSALS

Under SEC rules, if a shareholder wants us to include a proposal in our proxy statement and form of proxy for the 2018 Annual Meeting of Shareholders, our Corporate Secretary must receive the proposal at our principal executive offices by November 22, 2017. Any such proposal must comply with the requirements of Rule 14a-8 promulgated under the Exchange Act.

Under our By-Laws, and as SEC rules permit, shareholders must follow certain procedures to nominate a person for election as a director at an annual or special meeting, or to introduce an item of business at an annual meeting (other than a proposal submitted under Rule 14a-8). Under these procedures, shareholders must submit the proposed nominee or item of business by delivering a notice to the Corporate Secretary at the following address: Corporate Secretary, Phillips 66, P.O. Box 4428, Houston, Texas 77210. We must receive notice as follows:

- We must receive notice of a shareholder's intention to introduce a nomination or proposed item of business for an annual meeting not less than 90 days nor more than 120 days before the first anniversary of the prior year's meeting. Assuming that our 2017 Annual Meeting is held on schedule, we must receive notice pertaining to the 2018 Annual Meeting no earlier than January 3, 2018, and no later than February 2, 2018.

- However, if we hold the annual meeting on a date that is not within 30 days before or after such anniversary date, and if our first public announcement of the date of such annual meeting is less than 100 days prior to the date of such meeting, we must receive the notice no later than 10 days after the public announcement of such meeting.

- If we hold a special meeting to elect directors, we must receive a shareholder's notice of intention to introduce a nomination no later than 10 days after the earlier of the date we first provide notice of the meeting to shareholders or announce it publicly.

As required by Article II of our By-Laws, a notice of a proposed nomination must include information about the shareholder and the nominee, as well as a written consent of the proposed nominee to serve if elected. A notice of a proposed item of business must include a description of and the reasons for bringing the proposed business to the meeting, any material interest of the shareholder in the business and certain other information about the shareholder. You can obtain a copy of our By-Laws by writing the Corporate Secretary at the address above, or via our website under the "*Governance*" caption.

AVAILABLE INFORMATION

SEC rules require us to provide an annual report to shareholders who receive this proxy statement. Additional printed copies of the annual report to shareholders, as well as our Corporate Governance Guidelines, Code of Business Ethics and Conduct, charters for each of the committees of the Board of Directors and our Annual Report on Form 10-K for the year ended December 31, 2016, including the financial statements and the financial statement schedules, are available without charge to shareholders upon written request to Phillips 66 Investor Relations Department, P.O. Box 4428, Houston, Texas 77210 or via the Internet at *www.Phillips66.com*. We will furnish the exhibits to our Annual Report on Form 10-K upon payment of our copying and mailing expenses.

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Appendix A

NON-GAAP FINANCIAL MEASURES

The discussion of our results in this proxy statement includes references to our "adjusted EBITDA," "PSP ROCE," and "adjusted controllable costs" amounts. These measures are not measures of financial performance under U.S. generally accepted accounting principles (GAAP) and may not be defined and calculated by other companies using the same or similar terminology.

Adjusted EBITDA

Adjusted EBITDA is a non-GAAP financial measure because it adjusts net income to exclude depreciation and amortization, net interest expense and income taxes, as well as certain items of expense or income that management does not consider representative of our core operating performance. We use this measure as a factor in assessing performance for the purposes of compensation decisions. A reconciliation of adjusted EBITDA to net income, the most directly comparable GAAP financial measure, is set forth below.

YEAR ENDED DECEMBER 31		**MILLIONS OF DOLLARS 2016**
Net Income	**$**	**1,644**
Plus:		
Provision for income taxes		547
Net interest expense		321
Depreciation and amortization (D&A)		1,168
EBITDA		3,680
Adjustments:		
EBITDA attributable to noncontrolling interests		(124)
Proportional share of selected equity affiliates income taxes		79
Proportional share of selected equity affiliates net interest		137
Proportional share of selected equity affiliates D&A		725
Impairments by equity affiliates		95
Pending claims and settlements		(115)
Equity affiliate ownership restructuring		33
Recognition of deferred logistics commitments		30
Railcar lease residual value deficiencies and related costs		40
Certain tax impacts		(32)
Adjusted EBITDA	**$**	**4,548**

PSP ROCE

We believe PSP ROCE is an important metric for evaluating the quality of capital allocation decisions, measuring portfolio value, and measuring the efficiency and profitability of capital investments. We use this measure as a factor in assessing performance for the purposes of compensation decisions. PSP ROCE is a ratio, the numerator of which is adjusted earnings plus after-tax interest expense, and the denominator of which is average adjusted total equity plus total debt.

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Our calculation of PSP ROCE, and its reconciliation to ROCE prepared using GAAP amounts, is set forth below.

	MILLIONS OF DOLLARS EXCEPT AS INDICATED				
YEARS ENDED DECEMBER 31	**PSP AVERAGE 2014 2016**		**2016**	**2015**	**2014**
PSP ROCE					
Numerator					
Net Income		$	1,644	4,280	4,797
After-tax interest expense			220	201	173
GAAP ROCE earnings			1,864	4,481	4,970
Adjustments*			(57)	(34)	(980)
PSP ROCE earnings			**1,807**	**4,447**	**3,990**
Denominator					
GAAP average capital employed**			33,344	31,749	29,595
In-process capital			(3,097)	(3,016)	(1,675)
Cash adjustment			(37)	(1,141)	(2,303)
PSP average capital employed		**$**	**30,210**	**27,592**	**25,617**
PSP ROCE (percent)	12.6%		6.0%	16.1%	15.6%
GAAP ROCE (percent)	12.2%		5.6%	14.1%	16.8%

*

Primarily related to gains on asset dispositions, impairments, certain tax impacts and pending claims and settlements.

**

Total equity plus total debt.

Adjusted Controllable Costs

Adjusted controllable costs is a measure of how effectively we manage costs versus internal targets. We use this measure as a factor in assessing performance for the purposes of compensation decisions. Adjusted controllable costs is a non-GAAP financial measure because it excludes certain costs that we believe are not directly relevant to compensation decisions. A reconciliation of adjusted controllable costs to the sum of operating expenses and selling, general and administrative expenses, the most directly comparable GAAP measures, is set forth below.

YEAR ENDED DECEMBER 31		**MILLIONS OF DOLLARS 2016**
Operating expenses	**$**	**4,275**
Selling, general and administrative expenses		**1,638**

Adjustments:		
Certain employee benefits		(82)
Asset disposition impacts		50
Foreign currency and utility price impacts		212
Adjusted controllable costs	**$**	**6,093**