

CITIZENS & NORTHERN CORP  
Form 10-Q  
November 03, 2016

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 **September 30, 2016**

or

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

Commission file number: 000-16084

**CITIZENS & NORTHERN CORPORATION**

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA                      23-2451943  
(State or other jurisdiction of      (I.R.S. Employer  
incorporation or organization)      Identification No.)

90-92 MAIN STREET, WELLSBORO, PA 16901

(Address of principal executive offices) (Zip code)

570-724-3411

(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  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  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 definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Common Stock (\$1.00 par value) 12,086,511 Shares Outstanding on October 31, 2016

**CITIZENS & NORTHERN CORPORATION**

**Index**

Part I. Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets (Unaudited) – September 30, 2016 and December 31, 2015 Page 3

Consolidated Statements of Income (Unaudited) – Three-month and Nine-month Periods Ended September 30, 2016 and 2015 Page 4

Consolidated Statements of Comprehensive Income (Unaudited) - Three-month and Nine-month Periods Ended September 30, 2016 and 2015 Page 5

Consolidated Statements of Cash Flows (Unaudited) – Nine Months Ended September 30, 2016 and 2015 Page 6

Consolidated Statements of Changes in Stockholders' Equity (Unaudited) - Nine Months Ended September 30, 2016 and 2015 Page 7

Notes to Unaudited Consolidated Financial Statements Pages 8 – 39

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Pages 40 – 60

Item 3. Quantitative and Qualitative Disclosures About Market Risk Pages 61 – 63

Item 4. Controls and Procedures Page 63

Part II. Other Information Pages 64 – 65

Signatures Page 66

Exhibit 31.1. Rule 13a-14(a)/15d-14(a) Certification - Chief Executive Officer

Exhibit 31.2. Rule 13a-14(a)/15d-14(a) Certification - Chief Financial Officer

Exhibit 32. Section 1350 Certifications

ITEM 1. FINANCIAL STATEMENTS  
CONSOLIDATED BALANCE SHEETS

| (In Thousands, Except Share and Per Share Data) (Unaudited)   | September<br>30,<br>2016 | December<br>31,<br>2015 |
|---|--------------------------|-------------------------|
| <b>ASSETS</b>   |                          |                         |
| Cash and due from banks:  |                          |                         |
| Noninterest-bearing   | \$ 20,482                | \$ 14,710               |
| Interest-bearing  | 13,588                   | 21,351                  |
| Total cash and due from banks   | 34,070                   | 36,061                  |
| Available-for-sale securities, at fair value  | 409,800                  | 420,290                 |
| Loans held for sale   | 621                      | 280                     |
| Loans receivable  | 742,338                  | 704,880                 |
| Allowance for loan losses   | (8,421)                  | (7,889)                 |
| Loans, net  | 733,917                  | 696,991                 |
| Bank-owned life insurance   | 19,608                   | 20,764                  |
| Accrued interest receivable   | 3,871                    | 3,768                   |
| Bank premises and equipment, net  | 15,406                   | 15,406                  |
| Foreclosed assets held for sale   | 2,321                    | 1,260                   |
| Deferred tax asset, net   | 1,544                    | 3,115                   |
| Intangible asset - Core deposit intangibles   | 21                       | 30                      |
| Intangible asset - Goodwill   | 11,942                   | 11,942                  |
| Other assets  | 12,212                   | 13,510                  |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,245,333</b>      | <b>\$ 1,223,417</b>     |
| <b>LIABILITIES</b>  |                          |                         |
| Deposits:   |                          |                         |
| Noninterest-bearing   | \$ 220,973               | \$ 211,041              |
| Interest-bearing  | 770,907                  | 724,574                 |
| Total deposits  | 991,880                  | 935,615                 |
| Short-term borrowings   | 14,590                   | 53,496                  |
| Long-term borrowings  | 38,538                   | 38,767                  |
| Accrued interest and other liabilities  | 9,722                    | 8,052                   |
| <b>TOTAL LIABILITIES</b>  | <b>1,054,730</b>         | <b>1,035,930</b>        |
| <b>STOCKHOLDERS' EQUITY</b>   |                          |                         |
| Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; no shares issued at September 30, 2016 and December 31, 2015  | 0                        | 0                       |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2016 and 2015; issued 12,655,171 at September 30, 2016 and December 31, 2015; outstanding 12,087,223 at September 30, 2016 and 12,180,623 December 31, 2015 | 12,655                   | 12,655                  |
| Paid-in capital   | 71,616                   | 71,654                  |
| Retained earnings   | 111,664                  | 109,454                 |
| Treasury stock, at cost; 567,948 shares at September 30, 2016 and 474,548 shares at December 31, 2015   | (10,762)                 | (8,804)                 |
| Sub-total   | 185,173                  | 184,959                 |

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|  |              |              |
|--|--------------|--------------|
| Accumulated other comprehensive income:          |              |              |
| Unrealized gain on available-for-sale securities | 5,388        | 2,493        |
| Defined benefit plans gain                       | 42           | 35           |
| Total accumulated other comprehensive income     | 5,430        | 2,528        |
| TOTAL STOCKHOLDERS' EQUITY                       | 190,603      | 187,487      |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY         | \$ 1,245,333 | \$ 1,223,417 |

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

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| Consolidated Statements of Income<br>(In Thousands Except Per Share Data) (Unaudited) | 3 Months Ended       |                   | 9 Months Ended       |                   |
|---|----------------------|-------------------|----------------------|-------------------|
|   | Sept.<br>30,<br>2016 | Sept. 30,<br>2015 | Sept.<br>30,<br>2016 | Sept. 30,<br>2015 |
| <b>INTEREST INCOME</b>  |                      |                   |                      |                   |
| Interest and fees on loans  | \$8,347              | \$7,851           | \$24,407             | \$23,313          |
| Interest on balances with depository institutions                                     | 29                   | 22                | 89                   | 73                |
| Interest on loans to political subdivisions   | 457                  | 470               | 1,357                | 1,210             |
| Interest on mortgages held for sale   | 7                    | 5                 | 21                   | 10                |
| Income from available-for-sale securities:  |                      |                   |                      |                   |
| Taxable   | 1,429                | 1,758             | 4,474                | 5,666             |
| Tax-exempt  | 835                  | 949               | 2,578                | 2,978             |
| Dividends   | 27                   | 79                | 66                   | 233               |
| Total interest and dividend income  | 11,131               | 11,134            | 32,992               | 33,483            |
| <b>INTEREST EXPENSE</b>   |                      |                   |                      |                   |
| Interest on deposits  | 549                  | 487               | 1,550                | 1,452             |
| Interest on short-term borrowings   | 30                   | 9                 | 133                  | 15                |
| Interest on long-term borrowings  | 365                  | 630               | 1,090                | 2,048             |
| Total interest expense  | 944                  | 1,126             | 2,773                | 3,515             |
| Net interest income   | 10,187               | 10,008            | 30,219               | 29,968            |
| Provision for loan losses   | 538                  | 302               | 1,224                | 526               |
| Net interest income after provision for loan losses                                   | 9,649                | 9,706             | 28,995               | 29,442            |
| <b>OTHER INCOME</b>   |                      |                   |                      |                   |
| Service charges on deposit accounts   | 1,221                | 1,302             | 3,523                | 3,629             |
| Service charges and fees  | 118                  | 137               | 335                  | 373               |
| Trust and financial management revenue  | 1,172                | 1,123             | 3,567                | 3,478             |
| Brokerage revenue   | 216                  | 215               | 569                  | 640               |
| Insurance commissions, fees and premiums  | 26                   | 24                | 74                   | 87                |
| Interchange revenue from debit card transactions                                      | 481                  | 482               | 1,431                | 1,456             |
| Net gains from sale of loans  | 236                  | 243               | 699                  | 573               |
| (Decrease) increase in fair value of servicing rights                                 | (68 )                | 13                | (247 )               | (137 )            |
| Increase in cash surrender value of life insurance                                    | 97                   | 95                | 286                  | 294               |
| Net (loss) from premises and equipment  | 0                    | (1 )              | 0                    | (1 )              |
| Other operating income  | 385                  | 328               | 1,243                | 1,087             |
| Sub-total   | 3,884                | 3,961             | 11,480               | 11,479            |
| Realized gains on available-for-sale securities, net                                  | 584                  | 79                | 1,089                | 1,085             |
| Total other income  | 4,468                | 4,040             | 12,569               | 12,564            |
| <b>OTHER EXPENSES</b>   |                      |                   |                      |                   |
| Salaries and wages  | 3,901                | 3,744             | 11,701               | 10,834            |
| Pensions and other employee benefits  | 1,060                | 1,016             | 3,499                | 3,336             |
| Occupancy expense, net  | 601                  | 623               | 1,770                | 1,985             |
| Furniture and equipment expense   | 435                  | 477               | 1,301                | 1,398             |
| FDIC Assessments  | 151                  | 155               | 448                  | 454               |
| Pennsylvania shares tax   | 287                  | 311               | 932                  | 946               |
| Professional fees   | 245                  | 141               | 816                  | 437               |
| Automated teller machine and interchange expense                                      | 291                  | 234               | 807                  | 735               |
| Software subscriptions  | 237                  | 209               | 729                  | 617               |

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|                                    |         |         |          |          |
|------------------------------------|---------|---------|----------|----------|
| Loss on prepayment of debt         | 0       | 0       | 0        | 910      |
| Other operating expense            | 1,371   | 1,207   | 4,183    | 3,872    |
| Total other expenses               | 8,579   | 8,117   | 26,186   | 25,524   |
| Income before income tax provision | 5,538   | 5,629   | 15,378   | 16,482   |
| Income tax provision               | 1,451   | 1,395   | 3,847    | 4,076    |
| NET INCOME                         | \$4,087 | \$4,234 | \$11,531 | \$12,406 |
| NET INCOME PER SHARE - BASIC       | \$0.34  | \$0.35  | \$0.95   | \$1.02   |
| NET INCOME PER SHARE - DILUTED     | \$0.34  | \$0.35  | \$0.95   | \$1.01   |

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

| Consolidated Statements of Comprehensive Income<br>(In Thousands) (Unaudited)  | 3 Months Ended<br>Sept. 30, |         | 9 Months Ended<br>Sept. 30, |          |
|--|-----------------------------|---------|-----------------------------|----------|
|  | 2016                        | 2015    | 2016                        | 2015     |
| Net income   | \$4,087                     | \$4,234 | \$11,531                    | \$12,406 |
| Unrealized (losses) gains on available-for-sale securities:  |                             |         |                             |          |
| Unrealized holding (losses) gains on available-for-sale securities   | (1,661)                     | 3,216   | 5,544                       | 2,369    |
| Reclassification adjustment for gains realized in income   | (584 )                      | (79 )   | (1,089 )                    | (1,085 ) |
| Other comprehensive (losses) gain on available-for-sale securities   | (2,245)                     | 3,137   | 4,455                       | 1,284    |
| Unfunded pension and postretirement obligations:   |                             |         |                             |          |
| Changes from plan amendments and actuarial gains and losses included in accumulated other comprehensive gain (loss)        | 0                           | 0       | 26                          | (100 )   |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (5 )                        | (3 )    | (15 )                       | (11 )    |
| Other comprehensive (loss) gain on unfunded retirement obligations   | (5 )                        | (3 )    | 11                          | (111 )   |
| Other comprehensive (loss) income before income tax  | (2,250)                     | 3,134   | 4,466                       | 1,173    |
| Income tax related to other comprehensive income (loss)  | 786                         | (1,098) | (1,564)                     | (411 )   |
| Net other comprehensive (loss) income  | (1,464)                     | 2,036   | 2,902                       | 762      |
| Comprehensive income   | \$2,623                     | \$6,270 | \$14,433                    | \$13,168 |

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

| CONSOLIDATED STATEMENTS OF CASH FLOWS<br>(In Thousands) (Unaudited)               | 9 Months Ended    |                   |
|---|-------------------|-------------------|
|   | Sept. 30,<br>2016 | Sept. 30,<br>2015 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                   |                   |
| Net income  | \$ 11,531         | \$ 12,406         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |                   |
| Provision for loan losses   | 1,224             | 526               |
| Realized gains on available-for-sale securities, net                              | (1,089 )          | (1,085 )          |
| Loss on prepayment of debt  | 0                 | 910               |
| Realized loss (gain) on foreclosed assets   | 86                | (37 )             |
| Loss on disposition of premises and equipment                                     | 0                 | 1                 |
| Depreciation expense  | 1,188             | 1,442             |
| Accretion and amortization on securities, net                                     | 1,065             | 1,204             |
| Accretion and amortization on loans and deposits, net                             | (11 )             | (16 )             |
| Decrease in fair value of servicing rights  | 247               | 137               |
| Increase in cash surrender value of life insurance                                | (286 )            | (294 )            |
| Stock-based compensation and other expense  | 484               | 459               |
| Amortization of core deposit intangibles  | 9                 | 16                |
| Deferred income taxes   | 7                 | 495               |
| Gains on sales of loans, net  | (699 )            | (573 )            |
| Origination of loans for sale   | (19,366)          | (16,613)          |
| Proceeds from sales of loans  | 19,565            | 16,975            |
| Increase in accrued interest receivable and other assets                          | (305 )            | (2,030 )          |
| Increase in accrued interest payable and other liabilities                        | 187               | 1,333             |
| Net Cash Provided by Operating Activities   | 13,837            | 15,256            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                   |                   |
| Proceeds from maturities of certificates of deposit                               | 1,060             | 0                 |
| Purchase of certificates of deposit   | (2,280 )          | 0                 |
| Proceeds from sales of available-for-sale securities                              | 21,573            | 25,972            |
| Proceeds from calls and maturities of available-for-sale securities               | 54,472            | 65,261            |
| Purchase of available-for-sale securities   | (59,582)          | (35,200)          |
| Redemption of Federal Home Loan Bank of Pittsburgh stock                          | 3,661             | 3,791             |
| Purchase of Federal Home Loan Bank of Pittsburgh stock                            | (2,364 )          | (4,674 )          |
| Net increase in loans   | (39,647)          | (52,273)          |
| Proceeds from bank owned life insurance   | 1,442             | 1,442             |
| Purchase of premises and equipment  | (1,188 )          | (733 )            |
| Return of principal on limited liability entity investments                       | 115               | 133               |
| Proceeds from sale of foreclosed assets   | 361               | 2,386             |
| Net Cash (Used in) Provided by Investing Activities                               | (22,377)          | 6,105             |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                   |                   |
| Net increase (decrease) in deposits   | 56,265            | (6,877 )          |
| Net (decrease) increase in short-term borrowings                                  | (38,906)          | 4,707             |
| Repayments of long-term borrowings  | (229 )            | (11,128)          |
| Purchase of treasury stock  | (3,723 )          | (3,944 )          |
| Sale of treasury stock  | 126               | 379               |
| Tax benefit from compensation plans   | 129               | 117               |
| Common dividends paid   | (8,333 )          | (8,441 )          |

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|  |          |          |
|--|----------|----------|
| Net Cash Provided by (Used in) Financing Activities      | 5,329    | (25,187) |
| DECREASE IN CASH AND CASH EQUIVALENTS                    | (3,211 ) | (3,826 ) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR             | 33,313   | 31,619   |
| CASH AND CASH EQUIVALENTS, END OF PERIOD                 | \$30,102 | \$27,793 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:       |          |          |
| Accrued purchase of available-for-sale securities        | \$1,494  | \$0      |
| Assets acquired through foreclosure of real estate loans | \$1,508  | \$2,523  |
| Interest paid  | \$2,764  | \$3,525  |
| Income taxes paid  | \$3,185  | \$3,295  |

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

**Consolidated Statements of Changes in Stockholders' Equity****(In Thousands Except Share and Per Share Data)****(Unaudited)**

|   | Common<br>Shares | Treasury<br>Shares | Common<br>Stock | Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury<br>Stock | Total      |
|---|------------------|--------------------|-----------------|--------------------|----------------------|---|-------------------|------------|
| Nine Months Ended<br>September 30, 2016                         |                  |                    |                 |                    |                      |   |                   |            |
| Balance, December 31,<br>2015                                   | 12,655,171       | 474,548            | \$ 12,655       | \$ 71,654          | \$ 109,454           | \$ 2,528  | \$(8,804 )        | \$ 187,487 |
| Net income  |                  |                    |                 |                    | 11,531               |   |                   | 11,531     |
| Other comprehensive<br>income, net                              |                  |                    |                 |                    |                      | 2,902   |                   | 2,902      |
| Cash dividends<br>declared on common<br>stock, \$0.78 per share |                  |                    |                 |                    | (9,435 )             |   |                   | (9,435 )   |
| Shares issued for<br>dividend reinvestment<br>plan              |                  | (53,596 )          |                 | 90                 |                      |   | 1,012             | 1,102      |
| Treasury stock<br>purchased                                     |                  | 187,300            |                 |                    |                      |   | (3,723 )          | (3,723 )   |
| Shares issued from<br>treasury for exercise of<br>stock options |                  | (7,371 )           |                 | (13 )              |                      |   | 139               | 126        |
| Restricted stock<br>granted                                     |                  | (35,427 )          |                 | (658 )             |                      |   | 658               | 0          |
| Forfeiture of restricted<br>stock                               |                  | 2,719              |                 | 48                 |                      |   | (48 )             | 0          |
| Stock-based<br>compensation expense                             |                  |                    |                 | 480                |                      |   |                   | 480        |
| Other stock-based<br>expense                                    |                  | (225 )             |                 |                    |                      |   | 4                 | 4          |
| Tax effect of stock<br>option exercises                         |                  |                    |                 | (2 )               |                      |   |                   | (2 )       |
| Tax benefit from<br>dividends on restricted<br>stock            |                  |                    |                 | 17                 |                      |   |                   | 17         |
| Tax benefit from<br>employee benefit plan                       |                  |                    |                 |                    | 114                  |   |                   | 114        |
| Balance, September<br>30, 2016                                  | 12,655,171       | 567,948            | \$ 12,655       | \$ 71,616          | \$ 111,664           | \$ 5,430  | \$(10,762)        | \$ 190,603 |

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|   |            |           |           |           |            |          |            |            |
|---|------------|-----------|-----------|-----------|------------|----------|------------|------------|
| Nine Months Ended   |            |           |           |           |            |          |            |            |
| September 30, 2015  |            |           |           |           |            |          |            |            |
| Balance, December 31, 2014                                | 12,655,171 | 375,191   | \$ 12,655 | \$ 71,541 | \$ 105,550 | \$ 5,360 | \$(6,744 ) | \$ 188,362 |
| Net income  |            |           |           |           | 12,406     |          |            | 12,406     |
| Other comprehensive income, net                           |            |           |           |           |            | 762      |            | 762        |
| Cash dividends declared on common stock, \$0.78 per share |            |           |           |           | (9,543 )   |          |            | (9,543 )   |
| Shares issued for dividend reinvestment plan              |            | (55,795 ) |           | 56        |            |          | 1,046      | 1,102      |
| Treasury stock purchased                                  |            | 203,100   |           |           |            |          | (3,944 )   | (3,944 )   |
| Shares issued from treasury for exercise of stock options |            | (22,335 ) |           | (26 )     |            |          | 405        | 379        |
| Restricted stock granted                                  |            | (34,800 ) |           | (627 )    |            |          | 627        | 0          |
| Forfeiture of restricted stock                            |            | 2,777     |           | 47        |            |          | (47 )      | 0          |
| Stock-based compensation expense                          |            |           |           | 459       |            |          |            | 459        |
| Tax effect of stock option exercises                      |            |           |           | (6 )      |            |          |            | (6 )       |
| Tax benefit from dividends on restricted stock            |            |           |           | 16        |            |          |            | 16         |
| Tax benefit from employee benefit plan                    |            |           |           |           | 107        |          |            | 107        |
| Balance, September 30, 2015                               | 12,655,171 | 468,138   | \$ 12,655 | \$ 71,460 | \$ 108,520 | \$ 6,122 | \$(8,657 ) | \$ 190,100 |

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

## Notes to Unaudited Consolidated Financial Statements

### 1. BASIS OF INTERIM PRESENTATION

The consolidated financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2015, is unaudited. Such information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations, comprehensive income, cash flows and changes in stockholders' equity for the interim periods; however, the information does not include all disclosures required by accounting principles generally accepted in the United States of America ("U.S. GAAP") for a complete set of financial statements. Certain 2015 information has been reclassified for consistency with the 2016 presentation.

Operating results reported for the three-month and nine-month periods ended September 30, 2016 might not be indicative of the results for the year ending December 31, 2016. The Corporation evaluates subsequent events through the date of filing with the Securities and Exchange Commission.

### 2. PER SHARE DATA

Net income per share is based on the weighted-average number of shares of common stock outstanding. The following data show the amounts used in computing basic and diluted net income per share. As shown in the table that follows, diluted earnings per share is computed using weighted average common shares outstanding, plus weighted-average common shares available from the exercise of all dilutive stock options, less the number of shares that could be repurchased with the proceeds of stock option exercises based on the average share price of the Corporation's common stock during the period.

|   | Net<br>Income | Weighted-<br>Average<br>Common<br>Shares | Earnings<br>Per<br>Share |
|---|---------------|--|--------------------------|
| Nine Months Ended September 30, 2016                                  |               |  |                          |
| Earnings per share – basic  | \$ 11,531,000 | 12,098,554                               | \$ 0.95                  |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 219,679                                  |                          |
| Hypothetical share repurchase at \$20.48                              |               | (195,659 )                               |                          |
| Earnings per share – diluted  | \$ 11,531,000 | 12,122,574                               | \$ 0.95                  |

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Nine Months Ended September 30, 2015

|   |               |            |         |
|---|---------------|------------|---------|
| Earnings per share – basic  | \$ 12,406,000 | 12,222,557 | \$ 1.02 |
| Dilutive effect of potential common stock arising from stock options: |               |            |         |
| Exercise of outstanding stock options                                 |               | 213,511    |         |
| Hypothetical share repurchase at \$19.94                              |               | (192,322 ) |         |
| Earnings per share – diluted  | \$ 12,406,000 | 12,243,746 | \$ 1.01 |

|   | Net<br>Income | Weighted-<br>Average<br>Common<br>Shares | Earnings<br>Per<br>Share |
|---|---------------|--|--------------------------|
| Three Months Ended September 30, 2016                                 |               |  |                          |
| Earnings per share – basic  | \$4,087,000   | 12,078,397                               | \$ 0.34                  |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 215,154                                  |                          |
| Hypothetical share repurchase at \$21.20                              |               | (185,355 )                               |                          |
| Earnings per share – diluted  | \$4,087,000   | 12,108,196                               | \$ 0.34                  |
| Three Months Ended September 30, 2015                                 |               |  |                          |
| Earnings per share – basic  | \$4,234,000   | 12,200,129                               | \$ 0.35                  |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 204,449                                  |                          |
| Hypothetical share repurchase at \$19.90                              |               | (184,248 )                               |                          |
| Earnings per share – diluted  | \$4,234,000   | 12,220,330                               | \$ 0.35                  |

Stock options that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 39,054 shares in the nine-month period ended September 30, 2016, 66,351 shares in the nine-month period ended September 30, 2015, 22,715 shares in the third quarter 2016 and 47,974 shares in the third quarter 2015.

### 3. COMPREHENSIVE INCOME

Comprehensive income is the total of (1) net income, and (2) all other changes in equity from non-stockholder sources, which are referred to as other comprehensive income. The components of other comprehensive income, and the related tax effects, are as follows:

| (In Thousands)  | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|---|----------------------|-------------------------|----------------------|
| Nine Months Ended September 30, 2016                        |                      |                         |                      |
| Unrealized gains on available-for-sale securities:          |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities   | \$ 5,544             | \$ (1,941 )             | \$ 3,603             |
| Reclassification adjustment for (gains) realized in income  | (1,089 )             | 381                     | (708 )               |
| Other comprehensive income on available-for-sale securities | 4,455                | (1,560 )                | 2,895                |
| Unfunded pension and postretirement obligations:            |                      |                         |                      |
|   | 26                   | (9 )                    | 17                   |

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|  |          |           |            |
|--|----------|-----------|------------|
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         |          |           |            |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (15      | ) 5       | (10 )      |
| Other comprehensive income on unfunded retirement obligations  | 11       | (4        | ) 7        |
| Total other comprehensive income   | \$ 4,466 | \$ (1,564 | ) \$ 2,902 |

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| Nine Months Ended September 30, 2015   |                      |                         |                      |
| Unrealized gains on available-for-sale securities:   |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities  | \$ 2,369             | \$ (829)                | ) \$ 1,540           |
| Reclassification adjustment for (gains) realized in income   | (1,085)              | ) 380                   | (705)                |
| Other comprehensive income on available-for-sale securities  | 1,284                | (449)                   | ) 835                |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         | (100)                | ) 35                    | (65)                 |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (11)                 | ) 3                     | (8)                  |
| Other comprehensive loss on unfunded retirement obligations  | (111)                | ) 38                    | (73)                 |
| Total other comprehensive income   | \$ 1,173             | \$ (411)                | ) \$ 762             |

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| Three Months Ended September 30, 2016  |                      |                         |                      |
| Unrealized losses on available-for-sale securities:  |                      |                         |                      |
| Unrealized holding losses on available-for-sale securities   | \$ (1,661)           | ) \$ 580                | \$ (1,081)           |
| Reclassification adjustment for (gains) realized in income   | (584)                | ) 204                   | (380)                |
| Other comprehensive loss on available-for-sale securities  | (2,245)              | ) 784                   | (1,461)              |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         | 0                    | 0                       | 0                    |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (5)                  | ) 2                     | (3)                  |
| Other comprehensive loss on unfunded retirement obligations  | (5)                  | ) 2                     | (3)                  |
| Total other comprehensive loss   | \$ (2,250)           | ) \$ 786                | \$ (1,464)           |

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| Three Months Ended September 30, 2015                      |                      |                         |                      |
| Unrealized gains on available-for-sale securities:         |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities  | \$ 3,216             | \$ (1,126)              | ) \$ 2,090           |
| Reclassification adjustment for (gains) realized in income | (79)                 | ) 28                    | (51)                 |
| Other comprehensive loss on available-for-sale securities  | 3,137                | (1,098)                 | ) 2,039              |

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Unfunded pension and postretirement obligations:

|  |          |             |          |
|--|----------|-------------|----------|
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         | 0        | 0           | 0        |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (3 )     | 0           | (3 )     |
| Other comprehensive loss on unfunded retirement obligations  | (3 )     | 0           | (3 )     |
| Total other comprehensive income   | \$ 3,134 | \$ (1,098 ) | \$ 2,036 |

Changes in the components of accumulated other comprehensive income are as follows and are presented net of tax:

| (In Thousands)   | Unrealized<br>Holding Gains<br>(Losses)<br>on Securities | Unfunded<br>Pension and<br>Postretirement<br>Obligations | Accumulated<br>Other<br>Comprehensive<br>Income |
|--|--|--|---|
| <b>Nine Months Ended September 30, 2016</b>                      |  |  |   |
| Balance, beginning of period                                     | \$ 2,493   | \$ 35  | \$ 2,528  |
| Other comprehensive income before reclassifications              | 3,603  | 17   | 3,620   |
| Amounts reclassified from accumulated other comprehensive income | (708)  | (10)   | (718)   |
| Other comprehensive income                                       | 2,895  | 7  | 2,902   |
| Balance, end of period   | \$ 5,388   | \$ 42  | \$ 5,430  |
| <b>Nine Months Ended September 30, 2015</b>                      |  |  |   |
| Balance, beginning of period                                     | \$ 5,281   | \$ 79  | \$ 5,360  |
| Other comprehensive income before reclassifications              | 1,540  | (65)   | 1,475   |
| Amounts reclassified from accumulated other comprehensive income | (705)  | (8)  | (713)   |
| Other comprehensive income                                       | 835  | (73)   | 762   |
| Balance, end of period   | \$ 6,116   | \$ 6   | \$ 6,122  |
| <b>Three Months Ended September 30, 2016</b>                     |  |  |   |
| Balance, beginning of period                                     | \$ 6,849   | \$ 45  | \$ 6,894  |
| Other comprehensive loss before reclassifications                | (1,081)  | 0  | (1,081)   |
| Amounts reclassified from accumulated other comprehensive income | (380)  | (3)  | (383)   |
| Other comprehensive loss   | (1,461)  | (3)  | (1,464)   |
| Balance, end of period   | \$ 5,388   | \$ 42  | \$ 5,430  |
| <b>Three Months Ended September 30, 2015</b>                     |  |  |   |
| Balance, beginning of period                                     | \$ 4,077   | \$ 9   | \$ 4,086  |
| Other comprehensive income before reclassifications              | 2,090  | 0  | 2,090   |
| Amounts reclassified from accumulated other comprehensive income | (51)   | (3)  | (54)  |
| Other comprehensive income                                       | 2,039  | (3)  | 2,036   |
| Balance, end of period   | \$ 6,116   | \$ 6   | \$ 6,122  |

Items reclassified out of each component of other comprehensive income are as follows:

For the Nine Months Ended September 30, 2016  
(In Thousands)

| Details about Accumulated Other Comprehensive Income Components   | Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Consolidated Statements of Income                                    |
|---|--|--|
| Unrealized gains and losses on available-for-sale securities      | \$ (1,089 )<br>381<br>(708 )                             | Realized gains on available-for-sale securities, net<br>Income tax provision<br>Net of tax     |
| Amortization of defined benefit pension and postretirement items: |  |  |
| Prior service cost  | (23 )  | Pensions and other employee benefits   |
| Actuarial loss  | 8<br>(15 )<br>5<br>(10 )                                 | Pensions and other employee benefits<br>Total before tax<br>Income tax provision<br>Net of tax |
| Total reclassifications for the period                            | \$ (718 )  |  |

For the Nine Months Ended September 30, 2015  
(In Thousands)

| Details about Accumulated Other Comprehensive Income Components   | Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Consolidated Statements of Income                                    |
|---|--|--|
| Unrealized gains and losses on available-for-sale securities      | \$ (1,085 )<br>380<br>(705 )                             | Realized gains on available-for-sale securities, net<br>Income tax provision<br>Net of tax     |
| Amortization of defined benefit pension and postretirement items: |  |  |
| Prior service cost  | (22 )  | Pensions and other employee benefits   |
| Actuarial loss  | 11<br>(11 )<br>3<br>(8 )                                 | Pensions and other employee benefits<br>Total before tax<br>Income tax provision<br>Net of tax |
| Total reclassifications for the period                            | \$ (713 )  |  |

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For the Three Months Ended September 30, 2016  
(In Thousands)

|   | Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Income | Affected Line Item in the Consolidated<br>Statements of Income                                       |
|---|---|--|
| Details about Accumulated Other                                   |   |  |
| Comprehensive Income Components                                   |   |  |
| Unrealized gains and losses on available-for-sale securities      | \$ (584<br>204<br>(380)   | ) Realized gains on available-for-sale securities, net<br>Income tax provision<br>) Net of tax       |
| Amortization of defined benefit pension and postretirement items: |   |  |
| Prior service cost  | (8  | ) Pensions and other employee benefits   |
| Actuarial loss  | 3<br>(5<br>2<br>(3  | ) Pensions and other employee benefits<br>) Total before tax<br>Income tax provision<br>) Net of tax |
| Total reclassifications for the period                            | \$ (383   | )  |

For the Three Months Ended September 30, 2015  
(In Thousands)

| Details about Accumulated Other Comprehensive Income Components   | Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Income | Affected Line Item in the Consolidated<br>Statements of Income                                 |
|---|---|--|
| Unrealized gains and losses on available-for-sale securities      | \$ (79<br>28<br>(51   | ) Realized gains on available-for-sale securities, net<br>Income tax provision<br>) Net of tax |
| Amortization of defined benefit pension and postretirement items: |   |  |
| Prior service cost  | (7  | ) Pensions and other employee benefits   |
| Actuarial loss  | 4<br>(3   | ) Pensions and other employee benefits<br>) Total before tax                                   |
|   | 0   | Income tax provision   |
|   | (3  | ) Net of tax   |
| Total reclassifications for the period                            | \$ (54  | )  |

#### 4. CASH AND DUE FROM BANKS

Cash and due from banks at September 30, 2016 and December 31, 2015 include the following:

| (In thousands)                | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|-------------------------------|-------------------|------------------|
| Cash and cash equivalents     | \$ 30,102         | \$ 33,313        |
| Certificates of deposit       | 3,968             | 2,748            |
| Total cash and due from banks | \$ 34,070         | \$ 36,061        |

Certificates of deposit are issued by U.S. banks with original maturities greater than three months. Each certificate of deposit is fully FDIC-insured. The Corporation maintains cash and cash equivalents with certain financial institutions in excess of the FDIC insurance limit.

The Corporation is required to maintain reserves against deposit liabilities in the form of cash and balances with the Federal Reserve Bank of Philadelphia. The reserves are based on deposit levels, account activity, and other services provided by the Federal Reserve Bank. Required reserves were \$13,141,000 at September 30, 2016 and \$15,327,000 at December 31, 2015.

## **5. FAIR VALUE MEASUREMENTS AND FAIR VALUES OF FINANCIAL INSTRUMENTS**

The Corporation measures certain assets at fair value. Fair value is defined as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. FASB Accounting Standards Codification (ASC) topic 820, “Fair Value Measurements and Disclosures” establishes a framework for measuring fair value that includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The levels of the fair value hierarchy are as follows:

Level 1 – Fair value is based on unadjusted quoted prices in active markets that are accessible to the Corporation for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.

Level 2 – Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices in markets that are not active for identical or similar assets and other observable inputs.

Level 3 – Fair value is based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows and other similar techniques.

The Corporation monitors and evaluates available data relating to fair value measurements on an ongoing basis and recognizes transfers among the levels of the fair value hierarchy as of the date of an event or change in circumstances that affects the valuation method chosen. Examples of such changes may include the market for a particular asset becoming active or inactive, changes in the availability of quoted prices, or changes in the availability of other market data.

At September 30, 2016 and December 31, 2015, assets measured at fair value and the valuation methods used are as follows:

| (In Thousands)  | September 30, 2016                                    |  |                                     |                        |
|---|---|--|-------------------------------------|------------------------|
|   | Quoted<br>Prices<br>in Active<br>Markets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair<br>Value |
| Recurring fair value measurements   |   |  |                                     |                        |
| AVAILABLE-FOR-SALE SECURITIES:  |   |  |                                     |                        |
| Obligations of U.S. Government agencies   | \$ 0  | \$9,747                                    | \$ 0                                | \$9,747                |
| Obligations of states and political subdivisions:   |   |  |                                     |                        |
| Tax-exempt  | 0   | 121,283                                    | 0                                   | 121,283                |
| Taxable   | 0   | 33,672                                     | 0                                   | 33,672                 |
| Mortgage-backed securities issued or guaranteed by U.S.<br>Government agencies or sponsored agencies: |   |  |                                     |                        |
| Residential pass-through securities   | 0   | 62,187                                     | 0                                   | 62,187                 |
| Residential collateralized mortgage obligations   | 0   | 165,719                                    | 0                                   | 165,719                |
| Commercial mortgage-backed securities   | 0   | 16,112                                     | 0                                   | 16,112                 |
| Total debt securities   | 0   | 408,720                                    | 0                                   | 408,720                |
| Marketable equity securities  | 1,080   | 0  | 0                                   | 1,080                  |
| Total available-for-sale securities   | 1,080   | 408,720                                    | 0                                   | 409,800                |
| Servicing rights  | 0   | 0  | 1,208                               | 1,208                  |
| Total recurring fair value measurements   | \$ 1,080  | \$408,720                                  | \$ 1,208                            | \$411,008              |
| Nonrecurring fair value measurements  |   |  |                                     |                        |
| Impaired loans with a valuation allowance   | \$ 0  | \$0  | \$ 3,621                            | \$3,621                |
| Valuation allowance   | 0   | 0  | (685)                               | (685)                  |
| Impaired loans, net   | 0   | 0  | 2,936                               | 2,936                  |
| Foreclosed assets held for sale   | 0   | 0  | 2,321                               | 2,321                  |

|  |      |     |          |         |
|--|------|-----|----------|---------|
| Total nonrecurring fair value measurements | \$ 0 | \$0 | \$ 5,257 | \$5,257 |
|--|------|-----|----------|---------|

| (In Thousands)  | Quoted<br>Prices<br>in Active<br>Markets<br>(Level 1) | December 31, 2015                          |                                     |                        |
|---|---|--|-------------------------------------|------------------------|
|   |   | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair<br>Value |
| Recurring fair value measurements   |   |  |                                     |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>   |   |  |                                     |                        |
| Obligations of U.S. Government agencies   | \$ 0  | \$ 10,483                                  | \$ 0                                | \$ 10,483              |
| Obligations of states and political subdivisions:   |   |  |                                     |                        |
| Tax-exempt  | 0   | 107,757                                    | 0                                   | 107,757                |
| Taxable   | 0   | 34,597                                     | 0                                   | 34,597                 |
| Mortgage-backed securities issued or guaranteed by U.S.<br>Government agencies or sponsored agencies: |   |  |                                     |                        |
| Residential pass-through securities   | 0   | 73,343                                     | 0                                   | 73,343                 |
| Residential collateralized mortgage obligations   | 0   | 191,715                                    | 0                                   | 191,715                |
| Collateralized debt obligations   | 0   | 9  | 0                                   | 9                      |
| Total debt securities   | 0   | 417,904                                    | 0                                   | 417,904                |
| Marketable equity securities  | 2,386   | 0  | 0                                   | 2,386                  |
| Total available-for-sale securities   | 2,386   | 417,904                                    | 0                                   | 420,290                |
| Servicing rights  | 0   | 0  | 1,296                               | 1,296                  |
| Total recurring fair value measurements   | \$ 2,386  | \$ 417,904                                 | \$ 1,296                            | \$ 421,586             |
| Nonrecurring fair value measurements  |   |  |                                     |                        |
| Impaired loans with a valuation allowance   | \$ 0  | \$ 0                                       | \$ 1,933                            | \$ 1,933               |
| Valuation allowance   | 0   | 0  | (820)                               | (820)                  |
| Impaired loans, net   | 0   | 0  | 1,113                               | 1,113                  |
| Foreclosed assets held for sale   | 0   | 0  | 1,260                               | 1,260                  |
| Total nonrecurring fair value measurements  | \$ 0  | \$ 0                                       | \$ 2,373                            | \$ 2,373               |

Management's evaluation and selection of valuation techniques and the unobservable inputs used in determining the fair values of assets valued using Level 3 methodologies include sensitive assumptions. Other market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amount calculated by management.

At September 30, 2016 and December 31, 2015, quantitative information regarding significant techniques and inputs used for assets measured on a recurring basis using unobservable inputs (Level 3 methodologies) are as follows:

| Asset | Fair Value at<br>9/30/16 | Valuation<br>Technique | Unobservable<br>Input(s) | Method or Value As of<br>9/30/16 |
|-------|--------------------------|------------------------|--------------------------|----------------------------------|
|-------|--------------------------|------------------------|--------------------------|----------------------------------|

|                  |                |                      |                        |          |  |
|------------------|----------------|----------------------|------------------------|----------|--|
| Servicing rights | (In Thousands) | Discounted cash flow | Discount rate          | 10.00 %  | Rate used through modeling period  |
|                  | \$ 1,208       |                      | Loan prepayment speeds | 194.00%  | Weighted-average PSA   |
|                  |                |                      | Servicing fees         | 0.25 %   | of loan balances   |
|                  |                |                      |                        | 4.00 %   | of payments are late   |
|                  |                |                      |                        | 5.00 %   | late fees assessed   |
|                  |                |                      |                        | \$ 1.94  | Miscellaneous fees per account per month   |
|                  |                |                      | Servicing costs        | \$ 6.00  | Monthly servicing cost per account   |
|                  |                |                      |                        | \$ 24.00 | Additional monthly servicing cost per loan on loans more than 30 days delinquent |
|                  |                |                      |                        | 1.50 %   | of loans more than 30 days delinquent  |
|                  |                |                      |                        | 3.00 %   | annual increase in servicing costs   |

| Asset               | Fair Value at<br>12/31/15<br>(In<br>Thousands) | Valuation<br>Technique  | Unobservable<br>Input(s)  | Method or Value As of<br>12/31/15   |
|---------------------|--|-------------------------|---------------------------|---|
| Servicing<br>rights | \$ 1,296                                       | Discounted<br>cash flow | Discount rate             | 10.00 % Rate used through modeling period   |
|                     |  |                         | Loan prepayment<br>speeds | 146.00% Weighted-average PSA  |
|                     |  |                         | Servicing fees            | 0.25 % of loan balances   |
|                     |  |                         |                           | 4.00 % of payments are late   |
|                     |  |                         |                           | 5.00 % late fees assessed   |
|                     |  |                         | Servicing costs           | \$ 1.94 Miscellaneous fees per account per month  |
|                     |  |                         |                           | \$ 6.00 Monthly servicing cost per account  |
|                     |  |                         |                           | \$ 24.00 Additional monthly servicing cost per<br>loan on loans more than 30 days<br>delinquent |
|                     |  |                         |                           | 1.50 % of loans more than 30 days delinquent  |
|                     |  |                         |                           | 3.00 % annual increase in servicing costs   |

The fair value of servicing rights is affected by expected future interest rates. Increases (decreases) in future expected interest rates tend to increase (decrease) the fair value of the Corporation's servicing rights because of changes in expected prepayment behavior by the borrowers on the underlying loans.

Following is a reconciliation of activity for Level 3 assets measured at fair value on a recurring basis:

| (In Thousands)                                 | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | Sept. 30,<br>2016  | Sept. 30,<br>2015 | Sept. 30,<br>2016 | Sept. 30,<br>2015 |
| Servicing rights balance, beginning of period  | \$ 1,224           | \$ 1,209          | \$ 1,296          | \$ 1,281          |
| Issuances of servicing rights                  | 52                 | 57                | 159               | 135               |
| Unrealized (losses) gains included in earnings | (68 )              | 13                | (247 )            | (137 )            |
| Servicing rights balance, end of period        | \$ 1,208           | \$ 1,279          | \$ 1,208          | \$ 1,279          |

Loans are classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Foreclosed assets held for sale consist of real estate acquired by foreclosure. For impaired commercial loans secured by real estate and foreclosed assets held for sale, estimated fair values are determined primarily using values from third-party appraisals. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

At September 30, 2016 and December 31, 2015, quantitative information regarding significant techniques and inputs used for nonrecurring fair value measurements using unobservable inputs (Level 3 methodologies) are as follows:

| (In Thousands, Except Percentages)                    |                    |                                |                       |                     |                             | Value at 9/30/16 (Weighted Average) |   |
|---|--------------------|--------------------------------|-----------------------|---------------------|-----------------------------|-------------------------------------|---|
| Asset   | Balance at 9/30/16 | Valuation Allowance at 9/30/16 | Fair Value at 9/30/16 | Valuation Technique | Unobservable Inputs         |                                     |   |
| <b>Impaired loans:</b>                                |                    |                                |                       |                     |                             |                                     |   |
| Residential mortgage loans - first liens              | \$ 0               | \$ 0                           | \$ 0                  | Sales comparison    | Discount to appraised value | 0                                   | % |
| <b>Commercial:</b>                                    |                    |                                |                       |                     |                             |                                     |   |
| Commercial loans secured by real estate               | 2,794              | 528                            | 2,266                 | Sales comparison    | Discount to appraised value | 7                                   | % |
| Commercial and industrial                             | 321                | 106                            | 215                   | Sales comparison    | Discount to appraised value | 35                                  | % |
| Commercial construction and land                      | 0                  | 0                              | 0                     | Sales comparison    | Discount to appraised value | 0                                   | % |
| Loans secured by farmland                             | 506                | 51                             | 455                   | Sales comparison    | Discount to appraised value | 55                                  | % |
| Multi-family (5 or more) residential                  | 0                  | 0                              | 0                     | Sales comparison    | Discount to appraised value | 0                                   | % |
| <b>Total impaired loans</b>                           | <b>\$ 3,621</b>    | <b>\$ 685</b>                  | <b>\$ 2,936</b>       |                     |                             |                                     |   |
| <b>Foreclosed assets held for sale - real estate:</b> |                    |                                |                       |                     |                             |                                     |   |
| Residential (1-4 family)                              | \$ 1,195           | \$ 0                           | \$ 1,195              | Sales comparison    | Discount to appraised value | 39                                  | % |
| Land  | 696                | 0                              | 696                   | Sales comparison    | Discount to appraised value | 29                                  | % |
| Commercial real estate                                | 430                | 0                              | 430                   | Sales comparison    | Discount to appraised value | 50                                  | % |
| <b>Total foreclosed assets held for sale</b>          | <b>\$ 2,321</b>    | <b>\$ 0</b>                    | <b>\$ 2,321</b>       |                     |                             |                                     |   |

| (In Thousands, Except<br>Percentages)             | Balance<br>at<br>12/31/15 | Valuation<br>Allowance<br>at<br>12/31/15 | Fair Value<br>at<br>12/31/15 | Valuation<br>Technique | Unobservable<br>Inputs         | Value<br>at<br>12/31/15<br>(Weighted<br>Average) |
|---|---------------------------|--|------------------------------|------------------------|--------------------------------|--|
| Asset   |                           |  |                              |                        |                                |  |
| Impaired loans:                                   |                           |  |                              |                        |                                |  |
| Residential mortgage loans - first<br>liens       | \$ 42                     | \$ 1                                     | \$ 41                        | Sales<br>comparison    | Discount to<br>appraised value | 31 %   |
| Commercial:                                       |                           |  |                              |                        |                                |  |
| Commercial loans secured by<br>real estate        | 317                       | 97                                       | 220                          | Sales<br>comparison    | Discount to<br>appraised value | 46 %   |
| Commercial and industrial                         | 75                        | 75                                       | 0                            | Sales<br>comparison    | Discount to<br>appraised value | 31 %   |
| Commercial construction and<br>land               | 0                         | 0  | 0                            | Sales<br>comparison    | Discount to<br>appraised value | 0 %  |
| Loans secured by farmland                         | 512                       | 52                                       | 460                          | Sales<br>comparison    | Discount to<br>appraised value | 49 %   |
| Multi-family (5 or more)<br>residential           | 987                       | 595                                      | 392                          | Sales<br>comparison    | Discount to<br>appraised value | 41 %   |
| Total impaired loans                              | \$ 1,933                  | \$ 820                                   | \$ 1,113                     |                        |                                |  |
| Foreclosed assets held for sale -<br>real estate: |                           |  |                              |                        |                                |  |
| Residential (1-4 family)                          | \$ 556                    | \$ 0                                     | \$ 556                       | Sales<br>comparison    | Discount to<br>appraised value | 32 %   |
| Land  | 704                       | 0  | 704                          | Sales<br>comparison    | Discount to<br>appraised value | 29 %   |
| Total foreclosed assets held for<br>sale          | \$ 1,260                  | \$ 0                                     | \$ 1,260                     |                        |                                |  |

Certain of the Corporation's financial instruments are not measured at fair value in the consolidated financial statements. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from disclosure requirements. Therefore, the aggregate fair value amounts presented may not represent the underlying fair value of the Corporation.

The Corporation used the following methods and assumptions in estimating fair value disclosures for financial instruments:

**CASH AND CASH EQUIVALENTS** - The carrying amounts of cash and short-term instruments approximate fair values.

**CERTIFICATES OF DEPOSIT** - Fair values for certificates of deposit, included in cash and due from banks in the consolidated balance sheet, are based on quoted market prices for certificates of similar remaining maturities.

**SECURITIES** - Fair values for securities, excluding restricted equity securities, are based on quoted market prices or other methods as described above. The carrying value of restricted equity securities approximates fair value based on applicable redemption provisions.

**LOANS HELD FOR SALE** - Fair values of loans held for sale are determined based on applicable sale prices available under the Federal Home Loan Banks' MPF Xtra and MPF Original programs.

**LOANS** - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage and other consumer. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories. The fair value of performing loans is calculated by discounting contractual cash flows, adjusted for estimated prepayments based on historical experience, using estimated market discount rates that reflect the credit and interest rate risk inherent in the loans. Fair value of nonperforming loans is based on recent appraisals or estimates prepared by the Corporation's lending officers.

**SERVICING RIGHTS** - The fair value of servicing rights, included in other assets in the consolidated balance sheet, is determined through a discounted cash flow valuation. Significant inputs include expected net servicing income, the discount rate and the expected prepayment speeds of the underlying loans.

**DEPOSITS** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable on demand at September 30, 2016 and December 31, 2015. The fair value of time deposits, such as certificates of deposit and Individual Retirement Accounts, is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates of deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

**BORROWED FUNDS** - The fair value of borrowings is estimated using discounted cash flow analyses based on rates currently available to the Corporation for similar types of borrowing arrangements.

**ACCRUED INTEREST** - The carrying amounts of accrued interest receivable and payable approximate fair values.

**OFF-BALANCE SHEET COMMITMENTS** - The Corporation has commitments to extend credit and has issued standby letters of credit. Standby letters of credit are conditional guarantees of performance by a customer to a third party. Estimates of the fair value of these off-balance sheet items were not made because of the short-term nature of these arrangements and the credit standing of the counterparties.

The estimated fair values, and related carrying amounts, of the Corporation's financial instruments are as follows:

| (In Thousands)  | Valuation Method(s) Used | Sept. 30, 2016  |            | December 31, 2015 |            |
|---|--------------------------|-----------------|------------|-------------------|------------|
|   |                          | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| Financial assets:                                       |                          |                 |            |                   |            |
| Cash and cash equivalents                               | Level 1                  | \$30,102        | \$30,102   | \$33,313          | \$33,313   |
| Certificates of deposit                                 | Level 2                  | 3,968           | 3,982      | 2,748             | 2,752      |
| Available-for-sale securities                           | See Above                | 409,800         | 409,800    | 420,290           | 420,290    |
| Restricted equity securities (included in Other Assets) | Level 2                  | 3,360           | 3,360      | 4,657             | 4,657      |
| Loans held for sale                                     | Level 2                  | 621             | 621        | 280               | 280        |
| Loans, net  | Level 3                  | 733,917         | 737,353    | 696,991           | 685,552    |
| Accrued interest receivable                             | Level 2                  | 3,871           | 3,871      | 3,768             | 3,768      |
| Servicing rights  | Level 3                  | 1,208           | 1,208      | 1,296             | 1,296      |
| Financial liabilities:                                  |                          |                 |            |                   |            |
| Deposits with no stated maturity                        | Level 2                  | 769,734         | 769,734    | 713,931           | 713,931    |
| Time deposits   | Level 2                  | 222,146         | 222,881    | 221,684           | 221,891    |
| Short-term borrowings                                   | Level 2                  | 14,590          | 14,497     | 53,496            | 53,398     |

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|                          |         |        |        |        |        |
|--------------------------|---------|--------|--------|--------|--------|
| Long-term borrowings     | Level 2 | 38,538 | 39,807 | 38,767 | 40,166 |
| Accrued interest payable | Level 2 | 79     | 79     | 70     | 70     |

**6. SECURITIES**

Amortized cost and fair value of available-for-sale securities at September 30, 2016 and December 31, 2015 are summarized as follows:

| (In Thousands)   | Amortized<br>Cost | September 30, 2016        |  | Fair<br>Value |
|--|-------------------|---------------------------|--|---------------|
|  |                   | Gross<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |               |
| Obligations of U.S. Government agencies  | \$ 9,667          | \$ 80                     | \$ 0                                     | \$ 9,747      |
| Obligations of states and political subdivisions:  |                   |                           |  |               |
| Tax-exempt   | 116,797           | 4,565                     | (79 )                                    | 121,283       |
| Taxable  | 32,764            | 908                       | 0  | 33,672        |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |                   |                           |  |               |
| Residential pass-through securities  | 60,966            | 1,221                     | 0  | 62,187        |
| Residential collateralized mortgage obligations  | 164,508           | 1,517                     | (306 )                                   | 165,719       |
| Commercial mortgage-backed securities  | 16,056            | 69                        | (13 )                                    | 16,112        |
| Total debt securities  | 400,758           | 8,360                     | (398 )                                   | 408,720       |
| Marketable equity securities   | 752               | 328                       | 0  | 1,080         |
| Total  | \$ 401,510        | \$ 8,688                  | \$ (398 )                                | \$ 409,800    |

| (In Thousands)   | Amortized<br>Cost | December 31, 2015         |  | Fair<br>Value |
|--|-------------------|---------------------------|--|---------------|
|  |                   | Gross<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |               |
| Obligations of U.S. Government agencies  | \$ 10,663         | \$ 12                     | \$ (192 )                                | \$ 10,483     |
| Obligations of states and political subdivisions:  |                   |                           |  |               |
| Tax-exempt   | 103,414           | 4,365                     | (22 )                                    | 107,757       |
| Taxable  | 34,317            | 381                       | (101 )                                   | 34,597        |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |                   |                           |  |               |
| Residential pass-through securities  | 73,227            | 486                       | (370 )                                   | 73,343        |
| Residential collateralized mortgage obligations  | 193,145           | 623                       | (2,053 )                                 | 191,715       |
| Collateralized debt obligations:   | 9                 | 0                         | 0  | 9             |
| Total debt securities  | 414,775           | 5,867                     | (2,738 )                                 | 417,904       |
| Marketable equity securities   | 1,680             | 706                       | 0  | 2,386         |
| Total  | \$ 416,455        | \$ 6,573                  | \$ (2,738 )                              | \$ 420,290    |



The following table presents gross unrealized losses and fair value of available-for-sale securities with unrealized loss positions that are not deemed to be other-than-temporarily impaired, aggregated by length of time that individual securities have been in a continuous unrealized loss position at September 30, 2016 and December 31, 2015:

| September 30, 2016<br>(In Thousands)   | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Obligations of states and political subdivisions, Tax-exempt                                       | \$ 15,448           | \$ (64 )          | \$ 1,001          | \$ (15 )          | \$ 16,449  | \$ (79 )          |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |                     |                   |                   |                   |            |                   |
| Residential collateralized mortgage obligations  | 19,303              | (38 )             | 24,426            | (268 )            | 43,729     | (306 )            |
| Commercial mortgage-backed securities  | 4,989               | (13 )             | 0                 | 0                 | 4,989      | (13 )             |
| Total temporarily impaired available-for-sale securities   | \$ 39,740           | \$ (115 )         | \$ 25,427         | \$ (283 )         | \$ 65,167  | \$ (398 )         |

| December 31, 2015<br>(In Thousands)  | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Obligations of U.S. Government agencies  | \$ 0                | \$ 0              | \$ 7,850          | \$ (192 )         | \$ 7,850   | \$ (192 )         |
| Obligations of states and political subdivisions:  |                     |                   |                   |                   |            |                   |
| Tax-exempt   | 5,200               | (19 )             | 216               | (3 )              | 5,416      | (22 )             |
| Taxable  | 10,605              | (60 )             | 2,910             | (41 )             | 13,515     | (101 )            |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored Agencies: |                     |                   |                   |                   |            |                   |
| Residential pass-through securities  | 38,764              | (295 )            | 3,503             | (75 )             | 42,267     | (370 )            |
| Residential collateralized mortgage obligations  | 88,355              | (648 )            | 49,273            | (1,405 )          | 137,628    | (2,053 )          |
| Total temporarily impaired available-for-sale securities   | \$ 142,924          | \$ (1,022 )       | \$ 63,752         | \$ (1,716 )       | \$ 206,676 | \$ (2,738 )       |

Gross realized gains and losses from available-for-sale securities were as follows:

| (In Thousands) | 3 Months Ended |           | 9 Months Ended |           |
|----------------|----------------|-----------|----------------|-----------|
|                | Sept. 30,      | Sept. 30, | Sept. 30,      | Sept. 30, |
|                |                |           |                |           |

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|                                  | 2016   | 2015   | 2016    | 2015     |
|----------------------------------|--------|--------|---------|----------|
| Gross realized gains from sales  | \$ 584 | \$ 156 | \$1,090 | \$ 1,162 |
| Gross realized losses from sales | 0      | (77 )  | (1 )    | (77 )    |
| Net realized gains               | \$ 584 | \$ 79  | \$1,089 | \$ 1,085 |

The amortized cost and fair value of available-for-sale debt securities by contractual maturity are shown in the following table as of September 30, 2016. Actual maturities may differ from contractual maturities because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands)   | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
| Due in one year or less  | \$ 16,631         | \$ 16,837     |
| Due from one year through five years   | 71,211            | 73,423        |
| Due from five years through ten years  | 47,463            | 49,076        |
| Due after ten years  | 23,923            | 25,366        |
| Sub-total  | 159,228           | 164,702       |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |                   |               |
| Residential pass-through securities  | 60,966            | 62,187        |
| Residential collateralized mortgage obligations  | 164,508           | 165,719       |
| Commercial mortgage-backed securities  | 16,056            | 16,112        |
| Total  | \$ 400,758        | \$ 408,720    |

The Corporation's mortgage-backed securities have stated maturities that may differ from actual maturities due to borrowers' ability to prepay obligations. Cash flows from such investments are dependent upon the performance of the underlying mortgage loans and are generally influenced by the level of interest rates. In the table above, mortgage-backed securities and collateralized mortgage obligations are shown in one period.

Investment securities carried at \$221,427,000 at September 30, 2016 and \$228,616,000 at December 31, 2015 were pledged as collateral for public deposits, trusts and certain other deposits as provided by law. See Note 8 for information concerning securities pledged to secure borrowing arrangements.

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security or more likely than not will be required to sell the security before its anticipated recovery.

A summary of information management considered in evaluating debt and equity securities for OTTI at September 30, 2016 is provided below.

## **Debt Securities**

At September 30, 2016, management performed an assessment for possible OTTI of the Corporation's debt securities on an issue-by-issue basis, relying on information obtained from various sources, including publicly available financial data, ratings by external agencies, brokers and other sources. The extent of individual analysis applied to each security depended on the size of the Corporation's investment, as well as management's perception of the credit risk associated with each security. Based on the results of the assessment, management believes impairment of debt securities at September 30, 2016 to be temporary.

## **Equity Securities**

The Corporation's marketable equity securities at September 30, 2016 and December 31, 2015 consisted exclusively of stocks of banking companies. At September 30, 2016, the Corporation held no stocks with an unrealized loss.

The Corporation realized gains from sales of bank stocks totaling \$560,000 in the three-month period ended September 30, 2016 and \$837,000 during the first nine months of 2016. There were no realized gains or losses on bank stocks in the three-month period ended September 30, 2015, while realized gains from sales of bank stocks totaled \$476,000 in the nine-month period ended September 30, 2015.

C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 11 regional Federal Home Loan Banks. As a member, C&N Bank is required to purchase and maintain stock in FHLB-Pittsburgh. There is no active market for FHLB-Pittsburgh stock, and it must ordinarily be redeemed by FHLB-Pittsburgh in order to be liquidated. C&N Bank's investment in FHLB-Pittsburgh stock, included in Other Assets in the consolidated balance sheet, was \$3,230,000 at September 30, 2016 and \$4,527,000 at December 31, 2015. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at September 30, 2016 and December 31, 2015. In making this determination, management concluded that recovery of total outstanding par value, which equals the carrying value, is expected. The decision was based on review of financial information that FHLB-Pittsburgh has made publicly available.

## 7. LOANS

The loans receivable portfolio is segmented into residential mortgage, commercial and consumer loans. Loans outstanding at September 30, 2016 and December 31, 2015 are summarized by segment, and by classes within each segment, as follows:

| Summary of Loans by Type<br>(In Thousands) | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|--|-------------------|------------------|
| Residential mortgage:                      |                   |                  |
| Residential mortgage loans - first liens   | \$325,533         | \$304,783        |
| Residential mortgage loans - junior liens  | 22,794            | 21,146           |
| Home equity lines of credit                | 38,623            | 39,040           |
| 1-4 Family residential construction        | 23,310            | 21,121           |
| Total residential mortgage                 | 410,260           | 386,090          |
| Commercial:                                |                   |                  |
| Commercial loans secured by real estate    | 149,938           | 154,779          |
| Commercial and industrial                  | 86,969            | 75,196           |
| Political subdivisions                     | 38,653            | 40,007           |
| Commercial construction and land           | 12,809            | 5,122            |
| Loans secured by farmland                  | 6,900             | 7,019            |
| Multi-family (5 or more) residential       | 8,133             | 9,188            |
| Agricultural loans                         | 4,313             | 4,671            |
| Other commercial loans                     | 11,557            | 12,152           |
| Total commercial                           | 319,272           | 308,134          |
| Consumer                                   | 12,806            | 10,656           |
| Total                                      | 742,338           | 704,880          |
| Less: allowance for loan losses            | (8,421 )          | (7,889 )         |
| Loans, net                                 | \$733,917         | \$696,991        |

The Corporation grants loans to individuals as well as commercial and tax-exempt entities. Commercial, residential and personal loans are made to customers geographically concentrated in the Pennsylvania and New York counties that comprise the market serviced by Citizens & Northern Bank. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. There is no concentration of loans to borrowers engaged in similar businesses or activities that exceed 10% of total loans at either September 30, 2016 or December 31, 2015.

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. In the process of evaluating the loan portfolio, management also considers the Corporation's exposure to losses from unfunded loan commitments. As of September 30, 2016 and December 31, 2015, management determined that no allowance for credit losses related to unfunded loan commitments was required.

Transactions within the allowance for loan losses, summarized by segment and class, for the three-month and nine-month periods ended September 30, 2016 and 2015 were as follows:

| Three Months Ended September 30, 2016<br>(In Thousands) | June 30,<br>2016<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | Sept. 30,<br>2016<br>Balance |
|---|-----------------------------|-------------|------------|-----------------------|------------------------------|
| Allowance for Loan Losses:                              |                             |             |            |                       |                              |
| Residential mortgage:                                   |                             |             |            |                       |                              |
| Residential mortgage loans - first liens                | \$ 2,830                    | \$ (31 )    | \$ 2       | \$ 155                | \$ 2,956                     |
| Residential mortgage loans - junior liens               | 239                         | 0           | 0          | 9                     | 248                          |
| Home equity lines of credit                             | 359                         | 0           | 0          | 0                     | 359                          |
| 1-4 Family residential construction                     | 222                         | 0           | 0          | 14                    | 236                          |
| Total residential mortgage                              | 3,650                       | (31 )       | 2          | 178                   | 3,799                        |
| Commercial:   |                             |             |            |                       |                              |
| Commercial loans secured by real estate                 | 2,083                       | 0           | 0          | 304                   | 2,387                        |
| Commercial and industrial                               | 1,038                       | (2 )        | 1          | 1                     | 1,038                        |
| Commercial construction and land                        | 105                         | 0           | 0          | 41                    | 146                          |
| Loans secured by farmland                               | 103                         | 0           | 0          | 3                     | 106                          |
| Multi-family (5 or more) residential                    | 248                         | 0           | 0          | (5 )                  | 243                          |
| Agricultural loans                                      | 47                          | 0           | 0          | (4 )                  | 43                           |
| Other commercial loans                                  | 119                         | 0           | 0          | (3 )                  | 116                          |
| Total commercial  | 3,743                       | (2 )        | 1          | 337                   | 4,079                        |
| Consumer  | 138                         | (28 )       | 12         | 23                    | 145                          |
| Unallocated   | 398                         | 0           | 0          | 0                     | 398                          |
| Total Allowance for Loan Losses                         | \$ 7,929                    | \$ (61 )    | \$ 15      | \$ 538                | \$ 8,421                     |

| Three Months Ended September 30, 2015<br>(In Thousands) | June 30,<br>2015<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | Sept. 30,<br>2015<br>Balance |
|---|-----------------------------|-------------|------------|-----------------------|------------------------------|
| Allowance for Loan Losses:                              |                             |             |            |                       |                              |
| Residential mortgage:                                   |                             |             |            |                       |                              |
| Residential mortgage loans - first liens                | \$ 2,775                    | \$ (12 )    | \$ 0       | \$ (112 )             | \$ 2,651                     |
| Residential mortgage loans - junior liens               | 210                         | (42 )       | 0          | 45                    | 213                          |
| Home equity lines of credit                             | 344                         | 0           | 0          | (5 )                  | 339                          |
| 1-4 Family residential construction                     | 257                         | 0           | 0          | 55                    | 312                          |
| Total residential mortgage                              | 3,586                       | (54 )       | 0          | (17 )                 | 3,515                        |
| Commercial:   |                             |             |            |                       |                              |
| Commercial loans secured by real estate                 | 1,692                       | 0           | 0          | 39                    | 1,731                        |
| Commercial and industrial                               | 800                         | 0           | 1          | 127                   | 928                          |
| Commercial construction and land                        | 296                         | (115 )      | 0          | (74 )                 | 107                          |
| Loans secured by farmland                               | 155                         | 0           | 0          | (45 )                 | 110                          |
| Multi-family (5 or more) residential                    | 80                          | 0           | 0          | 231                   | 311                          |
| Agricultural loans                                      | 40                          | 0           | 0          | 3                     | 43                           |
| Other commercial loans                                  | 120                         | 0           | 0          | 1                     | 121                          |

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|                                 |          |         |   |       |        |          |
|---------------------------------|----------|---------|---|-------|--------|----------|
| Total commercial                | 3,183    | (115    | ) | 1     | 282    | 3,351    |
| Consumer                        | 135      | (28     | ) | 10    | 6      | 123      |
| Unallocated                     | 396      | 0       |   | 0     | 31     | 427      |
| Total Allowance for Loan Losses | \$ 7,300 | \$ (197 | ) | \$ 11 | \$ 302 | \$ 7,416 |

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| Nine Months Ended September 30, 2016<br>(In Thousands) | Dec. 31,<br>2015<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | Sept. 30,<br>2016<br>Balance |
|--|-----------------------------|-------------|------------|-----------------------|------------------------------|
| Allowance for Loan Losses:                             |                             |             |            |                       |                              |
| Residential mortgage:                                  |                             |             |            |                       |                              |
| Residential mortgage loans - first liens               | \$ 2,645                    | \$ (73 )    | \$ 2       | \$ 382                | \$ 2,956                     |
| Residential mortgage loans - junior liens              | 219                         | 0           | 0          | 29                    | 248                          |
| Home equity lines of credit                            | 347                         | 0           | 0          | 12                    | 359                          |
| 1-4 Family residential construction                    | 207                         | 0           | 0          | 29                    | 236                          |
| Total residential mortgage                             | 3,418                       | (73 )       | 2          | 452                   | 3,799                        |
| Commercial:  |                             |             |            |                       |                              |
| Commercial loans secured by real estate                | 1,939                       | 0           | 2          | 446                   | 2,387                        |
| Commercial and industrial                              | 981                         | (2 )        | 2          | 57                    | 1,038                        |
| Commercial construction and land                       | 58                          | 0           | 0          | 88                    | 146                          |
| Loans secured by farmland                              | 106                         | 0           | 0          | 0                     | 106                          |
| Multi-family (5 or more) residential                   | 675                         | (595 )      | 0          | 163                   | 243                          |
| Agricultural loans                                     | 45                          | 0           | 0          | (2 )                  | 43                           |
| Other commercial loans                                 | 118                         | 0           | 0          | (2 )                  | 116                          |
| Total commercial                                       | 3,922                       | (597 )      | 4          | 750                   | 4,079                        |
| Consumer   | 122                         | (67 )       | 39         | 51                    | 145                          |
| Unallocated  | 427                         | 0           | 0          | (29 )                 | 398                          |
| Total Allowance for Loan Losses                        | \$ 7,889                    | \$ (737 )   | \$ 45      | \$ 1,224              | \$ 8,421                     |

| Nine Months Ended September 30, 2015<br>(In Thousands) | Dec. 31,<br>2014<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | Sept. 30,<br>2015<br>Balance |
|--|-----------------------------|-------------|------------|-----------------------|------------------------------|
| Allowance for Loan Losses:                             |                             |             |            |                       |                              |
| Residential mortgage:                                  |                             |             |            |                       |                              |
| Residential mortgage loans - first liens               | \$ 2,941                    | \$ (149 )   | \$ 1       | \$ (142 )             | \$ 2,651                     |
| Residential mortgage loans - junior liens              | 176                         | (42 )       | 0          | 79                    | 213                          |
| Home equity lines of credit                            | 322                         | 0           | 0          | 17                    | 339                          |
| 1-4 Family residential construction                    | 214                         | 0           | 0          | 98                    | 312                          |
| Total residential mortgage                             | 3,653                       | (191 )      | 1          | 52                    | 3,515                        |
| Commercial:  |                             |             |            |                       |                              |
| Commercial loans secured by real estate                | 1,758                       | (115 )      | 0          | 88                    | 1,731                        |
| Commercial and industrial                              | 688                         | (10 )       | 5          | 245                   | 928                          |
| Commercial construction and land                       | 283                         | (115 )      | 0          | (61 )                 | 107                          |
| Loans secured by farmland                              | 165                         | 0           | 0          | (55 )                 | 110                          |
| Multi-family (5 or more) residential                   | 87                          | 0           | 0          | 224                   | 311                          |
| Agricultural loans                                     | 31                          | 0           | 0          | 12                    | 43                           |
| Other commercial loans                                 | 131                         | 0           | 0          | (10 )                 | 121                          |
| Total commercial                                       | 3,143                       | (240 )      | 5          | 443                   | 3,351                        |
| Consumer   | 145                         | (65 )       | 44         | (1 )                  | 123                          |
| Unallocated  | 395                         | 0           | 0          | 32                    | 427                          |
| Total Allowance for Loan Losses                        | \$ 7,336                    | \$ (496 )   | \$ 50      | \$ 526                | \$ 7,416                     |



In the evaluation of the loan portfolio, management determines two major components for the allowance for loan losses – (1) a specific component based on an assessment of certain larger relationships, mainly commercial purpose loans, on a loan-by-loan basis; and (2) a general component for the remainder of the portfolio based on a collective evaluation of pools of loans with similar risk characteristics. The general component is assigned to each pool of loans based on both historical net charge-off experience, and an evaluation of certain qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management’s estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the above methodologies for estimating specific and general losses in the portfolio.

In determining the larger loan relationships for detailed assessment under the specific allowance component, the Corporation uses an internal risk rating system. Under the risk rating system, the Corporation classifies problem or potential problem loans as “Special Mention,” “Substandard,” or “Doubtful” on the basis of currently existing facts, conditions and values. Substandard loans include those characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Loans classified as Doubtful have all the weaknesses inherent in those classified as Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Loans that do not currently expose the Corporation to sufficient risk to warrant classification as Substandard or Doubtful, but possess weaknesses that deserve management’s close attention, are deemed to be Special Mention. Risk ratings are updated any time that conditions or the situation warrants. Loans not classified are included in the “Pass” column in the table below.

The following tables summarize the aggregate credit quality classification of outstanding loans by risk rating as of September 30, 2016 and December 31, 2015:

September 30, 2016

(In Thousands)

|   | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| <b>Residential Mortgage:</b>              |           |                    |             |          |           |
| Residential mortgage loans - first liens  | \$315,849 | \$ 331             | \$ 9,292    | \$ 61    | \$325,533 |
| Residential mortgage loans - junior liens | 22,376    | 145                | 273         | 0        | 22,794    |
| Home equity lines of credit               | 37,925    | 124                | 574         | 0        | 38,623    |
| 1-4 Family residential construction       | 23,310    | 0                  | 0           | 0        | 23,310    |
| Total residential mortgage                | 399,460   | 600                | 10,139      | 61       | 410,260   |
| <b>Commercial:</b>                        |           |                    |             |          |           |
| Commercial loans secured by real estate   | 133,140   | 3,087              | 13,711      | 0        | 149,938   |
| Commercial and Industrial                 | 82,076    | 4,196              | 686         | 11       | 86,969    |
| Political subdivisions                    | 38,653    | 0                  | 0           | 0        | 38,653    |
| Commercial construction and land          | 12,707    | 66                 | 36          | 0        | 12,809    |
| Loans secured by farmland                 | 5,243     | 168                | 1,472       | 17       | 6,900     |
| Multi-family (5 or more) residential      | 7,505     | 0                  | 628         | 0        | 8,133     |
| Agricultural loans                        | 3,503     | 0                  | 810         | 0        | 4,313     |

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|                        |           |          |           |       |           |
|------------------------|-----------|----------|-----------|-------|-----------|
| Other commercial loans | 11,482    | 0        | 75        | 0     | 11,557    |
| Total commercial       | 294,309   | 7,517    | 17,418    | 28    | 319,272   |
| Consumer               | 12,651    | 0        | 155       | 0     | 12,806    |
| Totals                 | \$706,420 | \$ 8,117 | \$ 27,712 | \$ 89 | \$742,338 |

December 31, 2015

(In Thousands)

|   | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| Residential Mortgage:                     |           |                    |             |          |           |
| Residential mortgage loans - first liens  | \$295,302 | \$ 407             | \$ 9,007    | \$ 67    | \$304,783 |
| Residential mortgage loans - junior liens | 20,558    | 185                | 403         | 0        | 21,146    |
| Home equity lines of credit               | 38,071    | 543                | 426         | 0        | 39,040    |
| 1-4 Family residential construction       | 21,104    | 17                 | 0           | 0        | 21,121    |
| Total residential mortgage                | 375,035   | 1,152              | 9,836       | 67       | 386,090   |
| Commercial:                               |           |                    |             |          |           |
| Commercial loans secured by real estate   | 140,381   | 5,862              | 8,536       | 0        | 154,779   |
| Commercial and Industrial                 | 71,225    | 2,106              | 1,737       | 128      | 75,196    |
| Political subdivisions                    | 40,007    | 0                  | 0           | 0        | 40,007    |
| Commercial construction and land          | 4,957     | 60                 | 105         | 0        | 5,122     |
| Loans secured by farmland                 | 5,084     | 483                | 1,432       | 20       | 7,019     |
| Multi-family (5 or more) residential      | 7,943     | 0                  | 1,245       | 0        | 9,188     |
| Agricultural loans                        | 4,655     | 0                  | 16          | 0        | 4,671     |
| Other commercial loans                    | 12,073    | 0                  | 79          | 0        | 12,152    |
| Total commercial                          | 286,325   | 8,511              | 13,150      | 148      | 308,134   |
| Consumer                                  | 10,490    | 21                 | 145         | 0        | 10,656    |
| Totals                                    | \$671,850 | \$ 9,684           | \$ 23,131   | \$ 215   | \$704,880 |

The general component of the allowance for loan losses covers pools of loans including commercial loans not considered individually impaired, as well as smaller balance homogeneous classes of loans, such as residential real estate, home equity lines of credit and other consumer loans. Accordingly, the Corporation generally does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are subject to a restructuring agreement. The pools of loans are evaluated for loss exposure based upon three-year average historical net charge-off rates for each loan class, adjusted for qualitative factors. Qualitative risk factors (described in the following paragraph) are evaluated for the impact on each of the three segments (residential mortgage, commercial and consumer) within the loan portfolio. Each qualitative factor is assigned a value to reflect improving, stable or declining conditions based on management's judgment using relevant information available at the time of the evaluation. The adjustment for qualitative factors is applied as an increase or decrease to the three-year average net charge-off rate to each loan class within each segment.

The qualitative factors used in the general component calculations are designed to address credit risk characteristics associated with each segment. The Corporation's credit risk associated with all of the segments is significantly impacted by these factors, which include economic conditions within its market area, the Corporation's lending policies, changes or trends in the portfolio, risk profile, competition, regulatory requirements and other factors. Further, the residential mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation's commercial segment loans (approximately 56% at September 30, 2016) is secured by real estate, and accordingly, the Corporation's risk for the commercial segment is significantly affected by commercial real estate values. The consumer segment includes a wide mix of loans for different purposes, primarily secured loans, including loans secured by motor vehicles, manufactured housing and other types of collateral.

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

The scope of loans evaluated individually for impairment include all loan relationships greater than \$200,000 for which there is at least one extension of credit graded Special Mention, Substandard or Doubtful. Also, all loans classified as troubled debt restructurings (discussed in more detail below) and all loan relationships less than \$200,000 in the aggregate, but with an estimated loss of \$100,000 or more, are individually evaluated for impairment. Loans that are individually evaluated for impairment, but which are not determined to be impaired, are combined with all remaining loans that are not reviewed on a specific basis, and such loans are included within larger pools of loans based on similar risk and loss characteristics for purposes of determining the general component of the allowance. The loans that have been individually evaluated, but which have not been determined to be impaired, are included in the “Collectively Evaluated” column in the tables summarizing the allowance and associated loan balances as of September 30, 2016 and December 31, 2015.

The following tables present a summary of loan balances and the related allowance for loan losses summarized by portfolio segment and class for each impairment method used as of September 30, 2016 and December 31, 2015:

| September 30, 2016<br>(In Thousands)      | Loans:                    |                           |                  | Allowance for Loan Losses: |                           |                |
|---|---------------------------|---------------------------|------------------|----------------------------|---------------------------|----------------|
|   | Individually<br>Evaluated | Collectively<br>Evaluated | Totals           | Individually<br>Evaluated  | Collectively<br>Evaluated | Totals         |
| <b>Residential mortgage:</b>              |                           |                           |                  |                            |                           |                |
| Residential mortgage loans - first liens  | \$734                     | \$324,799                 | \$325,533        | \$0                        | \$2,956                   | \$2,956        |
| Residential mortgage loans - junior liens | 70                        | 22,724                    | 22,794           | 0                          | 248                       | 248            |
| Home equity lines of credit               | 0                         | 38,623                    | 38,623           | 0                          | 359                       | 359            |
| 1-4 Family residential construction       | 0                         | 23,310                    | 23,310           | 0                          | 236                       | 236            |
| Total residential mortgage                | 804                       | 409,456                   | 410,260          | 0                          | 3,799                     | 3,799          |
| <b>Commercial:</b>                        |                           |                           |                  |                            |                           |                |
| Commercial loans secured by real estate   | 8,088                     | 141,850                   | 149,938          | 528                        | 1,859                     | 2,387          |
| Commercial and industrial                 | 439                       | 86,530                    | 86,969           | 106                        | 932                       | 1,038          |
| Political subdivisions                    | 0                         | 38,653                    | 38,653           | 0                          | 0                         | 0              |
| Commercial construction and land          | 0                         | 12,809                    | 12,809           | 0                          | 146                       | 146            |
| Loans secured by farmland                 | 1,399                     | 5,501                     | 6,900            | 51                         | 55                        | 106            |
| Multi-family (5 or more) residential      | 392                       | 7,741                     | 8,133            | 0                          | 243                       | 243            |
| Agricultural loans                        | 13                        | 4,300                     | 4,313            | 0                          | 43                        | 43             |
| Other commercial loans                    | 0                         | 11,557                    | 11,557           | 0                          | 116                       | 116            |
| Total commercial                          | 10,331                    | 308,941                   | 319,272          | 685                        | 3,394                     | 4,079          |
| Consumer                                  | 0                         | 12,806                    | 12,806           | 0                          | 145                       | 145            |
| Unallocated                               |                           |                           |                  |                            |                           | 398            |
| <b>Total</b>                              | <b>\$11,135</b>           | <b>\$731,203</b>          | <b>\$742,338</b> | <b>\$685</b>               | <b>\$7,338</b>            | <b>\$8,421</b> |

| December 31, 2015<br>(In Thousands)       | Loans:         |                   |                  | Allowance for Loan Losses: |                 |                 |
|---|----------------|-------------------|------------------|----------------------------|-----------------|-----------------|
|   | Individual     | Collectively      | Totals           | Individual                 | Collectively    | Totals          |
|   | Evaluated      | Evaluated         |                  | Evaluated                  | Evaluated       |                 |
| <b>Residential mortgage:</b>              |                |                   |                  |                            |                 |                 |
| Residential mortgage loans - first liens  | \$884          | \$ 303,899        | \$304,783        | \$ 1                       | \$ 2,644        | \$ 2,645        |
| Residential mortgage loans - junior liens | 74             | 21,072            | 21,146           | 0                          | 219             | 219             |
| Home equity lines of credit               | 0              | 39,040            | 39,040           | 0                          | 347             | 347             |
| 1-4 Family residential construction       | 0              | 21,121            | 21,121           | 0                          | 207             | 207             |
| Total residential mortgage                | 958            | 385,132           | 386,090          | 1                          | 3,417           | 3,418           |
| <b>Commercial:</b>                        |                |                   |                  |                            |                 |                 |
| Commercial loans secured by real estate   | 6,262          | 148,517           | 154,779          | 97                         | 1,842           | 1,939           |
| Commercial and industrial                 | 324            | 74,872            | 75,196           | 75                         | 906             | 981             |
| Political subdivisions                    | 0              | 40,007            | 40,007           | 0                          | 0               | 0               |
| Commercial construction and land          | 0              | 5,122             | 5,122            | 0                          | 58              | 58              |
| Loans secured by farmland                 | 1,427          | 5,592             | 7,019            | 52                         | 54              | 106             |
| Multi-family (5 or more) residential      | 987            | 8,201             | 9,188            | 595                        | 80              | 675             |
| Agricultural loans                        | 16             | 4,655             | 4,671            | 0                          | 45              | 45              |
| Other commercial loans                    | 0              | 12,152            | 12,152           | 0                          | 118             | 118             |
| Total commercial                          | 9,016          | 299,118           | 308,134          | 819                        | 3,103           | 3,922           |
| Consumer                                  | 0              | 10,656            | 10,656           | 0                          | 122             | 122             |
| Unallocated                               |                |                   |                  |                            |                 | 427             |
| <b>Total</b>                              | <b>\$9,974</b> | <b>\$ 694,906</b> | <b>\$704,880</b> | <b>\$ 820</b>              | <b>\$ 6,642</b> | <b>\$ 7,889</b> |

Summary information related to impaired loans at September 30, 2016 and December 31, 2015 is as follows:

| (In Thousands)                             | September 30, 2016             |                        |                      | December 31, 2015              |                        |                      |
|--|--------------------------------|------------------------|----------------------|--------------------------------|------------------------|----------------------|
|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance |
| <b>With no related allowance recorded:</b> |                                |                        |                      |                                |                        |                      |
| Residential mortgage loans - first liens   | \$764                          | \$ 734                 | \$ 0                 | \$842                          | \$ 842                 | \$ 0                 |
| Residential mortgage loans - junior liens  | 70                             | 70                     | 0                    | 74                             | 74                     | 0                    |
| Commercial loans secured by real estate    | 7,003                          | 5,294                  | 0                    | 7,580                          | 5,945                  | 0                    |
| Commercial and industrial                  | 118                            | 118                    | 0                    | 249                            | 249                    | 0                    |
| Loans secured by farmland                  | 893                            | 893                    | 0                    | 915                            | 915                    | 0                    |
| Multi-family (5 or more) residential       | 987                            | 392                    | 0                    | 0                              | 0                      | 0                    |
| Agricultural loans                         | 13                             | 13                     | 0                    | 16                             | 16                     | 0                    |
| Total with no related allowance recorded   | 9,848                          | 7,514                  | 0                    | 9,676                          | 8,041                  | 0                    |
| <b>With a related allowance recorded:</b>  |                                |                        |                      |                                |                        |                      |
| Residential mortgage loans - first liens   | 0                              | 0                      | 0                    | 42                             | 42                     | 1                    |
| Commercial loans secured by real estate    | 2,794                          | 2,794                  | 528                  | 317                            | 317                    | 97                   |

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|   |          |           |        |          |          |        |
|---|----------|-----------|--------|----------|----------|--------|
| Commercial and industrial               | 321      | 321       | 106    | 75       | 75       | 75     |
| Loans secured by farmland               | 506      | 506       | 51     | 512      | 512      | 52     |
| Multi-family (5 or more) residential    | 0        | 0         | 0      | 987      | 987      | 595    |
| Consumer                                | 0        | 0         | 0      | 0        | 0        | 0      |
| Total with a related allowance recorded | 3,621    | 3,621     | 685    | 1,933    | 1,933    | 820    |
| Total                                   | \$13,469 | \$ 11,135 | \$ 685 | \$11,609 | \$ 9,974 | \$ 820 |

The average balance of impaired loans and interest income recognized on impaired loans is as follows:

| (In Thousands)                           | Average Investment in Impaired Loans |           |                |           | Interest Income Recognized on Impaired Loans on a Cash Basis |        |                |        |
|--|--------------------------------------|-----------|----------------|-----------|--|--------|----------------|--------|
|  | 3 Months Ended                       |           | 9 Months Ended |           | 3 Months Ended   |        | 9 Months Ended |        |
|  | Sept. 30,                            |           | Sept. 30,      |           | Sept. 30,  |        | Sept. 30,      |        |
|  | 2016                                 | 2015      | 2016           | 2015      | 2016   | 2015   | 2016           | 2015   |
| Residential mortgage:                    |                                      |           |                |           |  |        |                |        |
| Residential mortgage loans - first lien  | \$ 789                               | \$ 1,990  | \$ 818         | \$ 2,534  | \$ 11  | \$ 9   | \$ 33          | \$ 67  |
| Residential mortgage loans - junior lien | 72                                   | 67        | 72             | 62        | 0  | 1      | 2              | 3      |
| Total residential mortgage               | 861                                  | 2,057     | 890            | 2,596     | 11   | 10     | 35             | 70     |
| Commercial:                              |                                      |           |                |           |  |        |                |        |
| Commercial loans secured by real estate  | 7,022                                | 6,327     | 6,524          | 6,382     | 83   | 90     | 274            | 293    |
| Commercial and industrial                | 577                                  | 421       | 619            | 467       | 7  | 4      | 17             | 16     |
| Commercial construction and land         | 0                                    | 42        | 0              | 50        | 0  | 0      | 0              | 0      |
| Loans secured by farmland                | 1,408                                | 1,466     | 1,413          | 1,467     | 13   | 26     | 51             | 78     |
| Multi-family (5 or more) residential     | 492                                  | 741       | 541            | 741       | 0  | 0      | 0              | 0      |
| Agricultural loans                       | 13                                   | 21        | 14             | 22        | 0  | 1      | 1              | 3      |
| Total commercial                         | 9,512                                | 9,018     | 9,111          | 9,129     | 103  | 121    | 343            | 390    |
| Consumer                                 | 17                                   | 0         | 16             | 0         | 0  | 0      | 0              | 0      |
| Total                                    | \$ 10,390                            | \$ 11,075 | \$ 10,017      | \$ 11,725 | \$ 114   | \$ 131 | \$ 378         | \$ 460 |

Loans are placed on nonaccrual status for all classes of loans when, in the opinion of management, collection of interest is doubtful. Any unpaid interest previously accrued on those loans is reversed from income. Interest income is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on loans for which the risk of further loss is greater than remote are applied as a reduction of the loan principal balance. Interest income on other nonaccrual loans, including impaired loans, is recognized only to the extent of interest payments received. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments. Also, the amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

The breakdown by portfolio segment and class of nonaccrual loans and loans past due ninety days or more and still accruing is as follows:

| (In Thousands) | September 30, 2016 |  | December 31, 2015 |  |
|----------------|--------------------|--|-------------------|--|
|                | Past               |  | Past              |  |
|                | Due                |  | Due               |  |

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|   | 90+<br>Days<br>and<br>Accruing | Nonaccrual | 90+<br>Days<br>and<br>Accruing | Nonaccrual |
|---|--------------------------------|------------|--------------------------------|------------|
| Residential mortgage:                     |                                |            |                                |            |
| Residential mortgage loans - first liens  | \$ 4,016                       | \$ 2,537   | \$ 2,381                       | \$ 3,044   |
| Residential mortgage loans - junior liens | 58                             | 0          | 79                             | 0          |
| Home equity lines of credit               | 106                            | 11         | 130                            | 0          |
| Total residential mortgage                | 4,180                          | 2,548      | 2,590                          | 3,044      |
| Commercial:                               |                                |            |                                |            |
| Commercial loans secured by real estate   | 2,795                          | 7,898      | 503                            | 5,730      |
| Commercial and industrial                 | 313                            | 193        | 65                             | 313        |
| Loans secured by farmland                 | 219                            | 1,399      | 0                              | 1,427      |
| Multi-family (5 or more) residential      | 0                              | 392        | 0                              | 987        |
| Agricultural loans                        | 16                             | 13         | 0                              | 16         |
| Total commercial                          | 3,343                          | 9,895      | 568                            | 8,473      |
| Consumer                                  | 16                             | 38         | 71                             | 0          |
| Totals                                    | \$ 7,539                       | \$ 12,481  | \$ 3,229                       | \$ 11,517  |

The amounts shown in the table immediately above include loans classified as troubled debt restructurings (described in more detail below), if such loans are past due ninety days or more or nonaccrual.

The table below presents a summary of the contractual aging of loans as of September 30, 2016 and December 31, 2015:

| (In Thousands)                            | As of September 30, 2016         |                           |                         |                  | As of December 31, 2015          |                           |                         |                  |
|---|----------------------------------|---------------------------|-------------------------|------------------|----------------------------------|---------------------------|-------------------------|------------------|
|   | Current &                        |                           |                         | Total            | Current &                        |                           |                         | Total            |
|   | Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days |                  | Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days |                  |
| <b>Residential mortgage:</b>              |                                  |                           |                         |                  |                                  |                           |                         |                  |
| Residential mortgage loans - first liens  | \$316,869                        | \$3,058                   | \$5,606                 | \$325,533        | \$294,703                        | \$6,156                   | \$3,924                 | \$304,783        |
| Residential mortgage loans - junior liens | 22,544                           | 192                       | 58                      | 22,794           | 20,816                           | 251                       | 79                      | 21,146           |
| Home equity lines of credit               | 38,143                           | 374                       | 106                     | 38,623           | 38,581                           | 329                       | 130                     | 39,040           |
| 1-4 Family residential construction       | 23,079                           | 231                       | 0                       | 23,310           | 21,121                           | 0                         | 0                       | 21,121           |
| <b>Total residential mortgage</b>         | <b>400,635</b>                   | <b>3,855</b>              | <b>5,770</b>            | <b>410,260</b>   | <b>375,221</b>                   | <b>6,736</b>              | <b>4,133</b>            | <b>386,090</b>   |
| <b>Commercial:</b>                        |                                  |                           |                         |                  |                                  |                           |                         |                  |
| Commercial loans secured by real estate   | 146,888                          | 107                       | 2,943                   | 149,938          | 153,427                          | 108                       | 1,244                   | 154,779          |
| Commercial and industrial                 | 86,637                           | 8                         | 324                     | 86,969           | 75,002                           | 118                       | 76                      | 75,196           |
| Political subdivisions                    | 38,653                           | 0                         | 0                       | 38,653           | 40,007                           | 0                         | 0                       | 40,007           |
| Commercial construction and land          | 12,801                           | 8                         | 0                       | 12,809           | 5,018                            | 104                       | 0                       | 5,122            |
| Loans secured by farmland                 | 5,807                            | 62                        | 1,031                   | 6,900            | 5,970                            | 223                       | 826                     | 7,019            |
| Multi-family (5 or more) residential      | 7,657                            | 84                        | 392                     | 8,133            | 8,201                            | 0                         | 987                     | 9,188            |
| Agricultural loans                        | 4,156                            | 128                       | 29                      | 4,313            | 4,642                            | 13                        | 16                      | 4,671            |
| Other commercial loans                    | 11,557                           | 0                         | 0                       | 11,557           | 12,152                           | 0                         | 0                       | 12,152           |
| <b>Total commercial</b>                   | <b>314,156</b>                   | <b>397</b>                | <b>4,719</b>            | <b>319,272</b>   | <b>304,419</b>                   | <b>566</b>                | <b>3,149</b>            | <b>308,134</b>   |
| Consumer                                  | 12,544                           | 208                       | 54                      | 12,806           | 10,537                           | 48                        | 71                      | 10,656           |
| <b>Totals</b>                             | <b>\$727,335</b>                 | <b>\$4,460</b>            | <b>\$10,543</b>         | <b>\$742,338</b> | <b>\$690,177</b>                 | <b>\$7,350</b>            | <b>\$7,353</b>          | <b>\$704,880</b> |

Nonaccrual loans are included in the contractual aging in the immediately preceding table. A summary of the contractual aging of nonaccrual loans at September 30, 2016 and December 31, 2015 is as follows:

| (In Thousands)                       | Current &         |            |          |  | Total     |
|--------------------------------------|-------------------|------------|----------|--|-----------|
|                                      | Past Due          | Past Due   | Past Due |  |           |
|                                      | Less than 30 Days | 30-89 Days | 90+ Days |  |           |
| September 30, 2016 Nonaccrual Totals | \$ 9,057          | \$ 420     | \$ 3,004 |  | \$ 12,481 |
| December 31, 2015 Nonaccrual Totals  | \$ 7,100          | \$ 293     | \$ 4,124 |  | \$ 11,517 |

Loans whose terms are modified are classified as Troubled Debt Restructurings (TDRs) if the Corporation grants such borrowers concessions, and it is deemed that those borrowers are experiencing financial difficulty. Loans classified as TDRs are designated as impaired. The outstanding balance of loans subject to TDRs, as well as contractual aging information at September 30, 2016 and December 31, 2015 is as follows:

| (In Thousands)            | Current &         |            |          | Nonaccrual | Total    |
|---------------------------|-------------------|------------|----------|------------|----------|
|                           | Past Due          | Past Due   | Past Due |            |          |
|                           | Less than 30 Days | 30-89 Days | 90+ Days |            |          |
| September 30, 2016 Totals | \$ 889            | \$ 57      | \$ 0     | \$ 5,032   | \$ 5,978 |
| December 31, 2015 Totals  | \$ 1,186          | \$ 0       | \$ 81    | \$ 5,097   | \$ 6,364 |

The TDR that occurred during the three-month period ended September 30, 2016 is as follows:

| Three Months Ended September 30, 2016<br>(Balances in Thousands) | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|--|---------------------------|---|--|
| Consumer   | 1                         | \$ 25   | \$ 25  |

There were no TDRs that occurred during the three-month period ended September 30, 2015.

The TDR in the three-month period ended September 30, 2016 represented a new, unsecured loan contract for \$25,000. The new loan contract was entered into pursuant to a settlement agreement with a borrower for whom the Corporation accepted a short fall from the sale of residential real estate as payment in full on a mortgage loan. At September 30, 2016, there was no allowance for loan losses related to this TDR and there were no changes to the allowance for loan losses related to this TDR in the third quarter 2016.

TDRs that occurred during the nine-month periods ended September 30, 2016 and 2015 were as follows:

| Nine Months Ended September 30, 2016<br>(Balances in Thousands)   | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|---|---------------------------|---|--|
| Residential mortgage,<br>Residential mortgage loans - first liens | 1                         | \$102   | \$102  |
| Commercial,<br>Commercial and Industrial                          | 1                         | 5   | 5  |
| Consumer  | 1                         | 25  | 25   |

| Nine Months Ended September 30, 2015<br>(Balances in Thousands) | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|---|---------------------------|---|--|
| Residential mortgage:   |                           |   |  |

|   |   |      |      |
|---|---|------|------|
| Residential mortgage loans - first liens  | 1 | \$56 | \$56 |
| Residential mortgage loans - junior liens | 1 | 32   | 32   |
| Consumer                                  | 1 | 30   | 30   |

The TDRs in the nine-month period ended September 30, 2016 included an extension of a final maturity date and a lowered interest rate on one contract on a residential mortgage – first lien, an extension of a final maturity date on a commercial and industrial loan, and establishment of an unsecured consumer loan contract pursuant to a settlement agreement with a borrower for whom the Corporation accepted a short fall from the sale of residential real estate as payment in full on a mortgage loan. In the third quarter 2016, a partial charge-off of \$31,000 was recorded on the residential mortgage –first lien. At September 30, 2016, there was no allowance for loan losses related to these TDRs, and except for the partial charge-off on the residential mortgage – first lien, no changes in the allowance for loan losses that resulted from these TDRs in the nine-month period ended September 30, 2016.

The TDRs in the nine-month period ended September 30, 2015 included an extended maturity date and a reduction in interest rate on a residential mortgage – first lien, a lowered interest rate and reduced payment amount on a residential mortgage – junior lien and a lowered interest rate and reduced payment amount on the consumer loan. There was no allowance for loan losses on these loans at September 30, 2015, and there was no change in the allowance for loan losses that resulted from these TDRs.

There were no defaults on loans for which modification considered to be TDRs were entered into within the previous 12 months in the three-month period ended September 30, 2016.

In the three-month period ended September 30, 2015, defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months were as follows:

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Three Months Ended September 30, 2015<br>(Balances in Thousands)  |                           |                        |
| Residential mortgage,<br>Residential mortgage loans - first liens | 1                         | \$ 32                  |

In the three-month period ended September 30, 2015, the event of default in the table listed above resulted from a borrower's failure to make regular payments after reduced payment amount period of six months ended on a first lien residential mortgage. There was no allowance for loan losses recorded on this loan at September 30, 2015.

In the nine-month periods ended September 30, 2016 and 2015, defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months were as follows:

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Nine Months Ended September 30, 2016<br>(Balances in Thousands) |                           |                        |
| Residential mortgage:   |                           |                        |
| Residential mortgage loans - first liens                        | 1                         | \$ 242                 |
| Residential mortgage loans - junior liens                       | 1                         | 30                     |
| Commercial,<br>Commercial and industrial                        | 1                         | 5                      |
| Consumer  | 1                         | 28                     |

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Nine Months Ended September 30, 2015<br>(Balances in Thousands)   |                           |                        |
| Residential mortgage,<br>Residential mortgage loans - first liens | 2                         | \$ 65                  |

Commercial,

Commercial construction and land

1

25

In the nine-month period ended September 30, 2016, the events of default in the table listed above resulted from the borrowers' failure to make timely payments under the following circumstances: (1) for the customer relationship in the Residential first lien mortgage class, payment was missed after the monthly payment amount was reduced for six months; (2) for the customer relationships in the Residential junior lien mortgage class and the consumer class, timely payments were missed after interest rates and payment amounts were reduced on both loans; and (3) for the Commercial and industrial loan, the borrower failed to pay off the loan at the extended maturity date. There was no allowance for loan losses recorded on these loans at September 30, 2016.

In the nine-month period ended September 30, 2015, the events of default in the table listed above resulted from the borrowers' failure to make timely payments under the following circumstances: (1) for one customer relationship included in the Residential first lien mortgage class, payment was missed after the interest rate and monthly payment amount had been reduced; (2) for the other customer relationship included in the Residential first lien class, monthly payments were missed after reducing the monthly payments to interest only payments; and (3) for the Commercial construction and land loan, monthly payments were missed after extending the term of maturity. There were no allowances for loan losses recorded on these loans at September 30, 2015.

The carrying amount of foreclosed residential real estate properties held as a result of obtaining physical possession (included in Foreclosed assets held for sale in the unaudited Consolidated Balance Sheet) is as follows:

| (In Thousands)                     | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|------------------------------------|-------------------|------------------|
| Foreclosed residential real estate | \$ 1,195          | \$ 555           |

The recorded investment of consumer mortgage loans secured by residential real properties for which formal foreclosure proceedings were in process is as follows:

| (In Thousands)                                    | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|---|-------------------|------------------|
| Residential real estate in process of foreclosure | \$ 1,991          | \$ 1,173         |

## 8. BORROWED FUNDS

Short-term borrowings include the following:

| (In Thousands)                 | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|--------------------------------|-------------------|------------------|
| FHLB-Pittsburgh borrowings     | \$ 8,270          | \$ 48,581        |
| Customer repurchase agreements | 6,320             | 4,915            |
| Total short-term borrowings    | \$ 14,590         | \$ 53,496        |

Short-term borrowings from FHLB-Pittsburgh are as follows:

| (In Thousands)                              | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|---|-------------------|------------------|
| Overnight borrowing                         | \$ 2,000          | \$ 23,500        |
| Other short-term advances                   | 6,270             | 25,081           |
| Total short-term FHLB-Pittsburgh borrowings | \$ 8,270          | \$ 48,581        |

The FHLB-Pittsburgh loan facilities are collateralized by qualifying loans secured by real estate with a book value totaling \$460,590,000 at September 30, 2016 and \$450,883,000 at December 31, 2015. Also, the FHLB-Pittsburgh loan facilities require the Corporation to invest in established amounts of FHLB-Pittsburgh stock. The carrying values of the Corporation's holdings of FHLB-Pittsburgh stock (included in Other Assets) were \$3,230,000 at September 30, 2016 and \$4,527,000 at December 31, 2015.

At September 30, 2016, short-term borrowings from the FHLB-Pittsburgh include 3 advances of approximately \$2,090,000 each, maturing monthly throughout the remainder of the year ending December 31, 2016, with a weighted average interest rate of 1.03% and rates ranging from 1.006% to 1.052%. In the first nine months of 2016, the Corporation repaid nine advances of approximately \$2,090,000 each, with a weighted average rate of 0.80%.

The Corporation engages in repurchase agreements with certain commercial customers. These agreements provide that the Corporation sells specified investment securities to the customers on an overnight basis and repurchases them on the following business day. The weighted average interest rate paid by the Corporation on customer repurchase agreements was 0.10% at September 30, 2016 and December 31, 2015. The carrying value of the underlying securities was \$16,472,000 at September 30, 2016 and \$12,613,000 at December 31, 2015.

Long-term borrowings are as follows:

| (In Thousands)             | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|----------------------------|-------------------|------------------|
| FHLB-Pittsburgh borrowings | \$ 11,538         | \$ 11,767        |
| Repurchase agreement       | 27,000            | 27,000           |
| Total long-term borrowings | \$ 38,538         | \$ 38,767        |

Long-term borrowings from FHLB-Pittsburgh are as follows:

| (In Thousands)                             | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|--|-------------------|------------------|
| Loan maturing in 2016 with a rate of 6.86% | \$ 18             | \$ 57            |
| Loan maturing in 2017 with a rate of 6.83% | 6                 | 10               |
| Loan maturing in 2017 with a rate of 3.81% | 10,000            | 10,000           |
| Loan maturing in 2020 with a rate of 4.79% | 691               | 821              |
| Loan maturing in 2025 with a rate of 4.91% | 823               | 879              |
| Total long-term FHLB-Pittsburgh borrowings | \$ 11,538         | \$ 11,767        |

The repurchase agreement included in long-term borrowings has an interest rate of 3.595% and an effective maturity date in December 2017.

The “Repurchase Date,” as defined in the Master Repurchase Agreement between the Corporation and the broker-dealer, occurs quarterly on or about the 20<sup>th</sup> of each March, June, September and December until the “Final Repurchase Date” (as defined) on December 20, 2017. The Corporation pays interest, and the borrowing is puttable by the issuer, on each Repurchase Date. The Final Repurchase Date is the effective maturity date of the borrowing.

Securities sold under repurchase agreements were delivered to the broker-dealer who is the counter-party to the transactions. The broker-dealer may have sold, loaned or otherwise disposed of such securities to other parties in the normal course of their operations, and has agreed to resell to the Corporation substantially identical securities at the maturities of the agreements. The Master Repurchase Agreement provides that the Agreement constitutes a “netting contract,” as defined; however, the Corporation and the broker-dealer have no other obligations to one another and accordingly, no netting has occurred.

The carrying value of the underlying securities was \$34,130,000 at September 30, 2016 and \$33,780,000 at December 31, 2015, detailed in the following table:

| (In Thousands)   | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|--|-------------------|------------------|
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |                   |                  |
| Residential pass-through securities  | \$ 19,444         | \$ 15,772        |
| Residential collateralized mortgage obligations  | 14,686            | 18,008           |
| Total  | \$ 34,130         | \$ 33,780        |

Two of the more significant risks associated with the repurchase agreement with the broker-dealer are as follows:

The borrowings are puttable at quarterly intervals by the issuer. Accordingly, if interest rates were to rise to a sufficient level, the issuer would be expected to require the Corporation to pay off the borrowing. In this circumstance, the Corporation would be required to obtain a new borrowing at a higher interest rate than the existing repurchase agreement or utilize cash from other sources to pay off the borrowing. If sales of available-for-sale securities were used to generate cash to pay off the borrowing, the value of such securities would be expected to have fallen, which could result in the Corporation recognizing a loss.

As principal pay-downs of mortgage backed securities and CMOs occur, the Corporation must have available, unencumbered assets or purchase a sufficient amount of assets with credit quality suitable to the broker-dealer to replace the amounts being paid off. Since pre-payments of mortgages typically increase as interest rates fall, the Corporation may be required to purchase additional assets at times when market rates are lower than the rates paid on the borrowing.

The Corporation manages these risks by maintaining sufficient available assets of acceptable credit quality, as well as maintaining other borrowing facilities, to meet ongoing collateral maintenance requirements or pay off the borrowing if required. In particular, the Corporation had unused borrowing capacity available from the FHLB-Pittsburgh of \$315,685,000 at September 30, 2016.

**9. DEFINED BENEFIT PLANS**

The Corporation sponsors a defined benefit health care plan that provides postretirement medical benefits and life insurance to employees who meet certain age and length of service requirements. Full-time employees no longer accrue service time toward the Corporation-subsidized portion of the medical benefits. This plan contains a cost-sharing feature, which causes participants to pay for all future increases in costs related to benefit coverage. Accordingly, actuarial assumptions related to health care cost trend rates do not significantly affect the liability balance at September 30, 2016 and December 31, 2015, and are not expected to significantly affect the Corporation's future expenses. The Corporation uses a December 31 measurement date for the postretirement plan.

In an acquisition in 2007, the Corporation assumed the Citizens Trust Company Retirement Plan, a defined benefit pension plan. This plan covers certain employees who were employed by Citizens Trust Company on December 31, 2002, when the plan was amended to discontinue admittance of any future participant and to freeze benefit accruals. Information related to the Citizens Trust Company Retirement Plan has been included in the tables that follow. The Corporation uses a December 31 measurement date for this plan.

The components of net periodic benefit costs from these defined benefit plans are as follows:

| Defined Benefit Plans<br>(In Thousands) | Pension                        |       | Postretirement                 |       |
|---|--------------------------------|-------|--------------------------------|-------|
|   | Nine Months Ended<br>Sept. 30, |       | Nine Months Ended<br>Sept. 30, |       |
|   | 2016                           | 2015  | 2016                           | 2015  |
| Service cost                            | \$ 0                           | \$ 0  | \$ 27                          | \$ 29 |
| Interest cost                           | 20                             | 27    | 47                             | 42    |
| Expected return on plan assets          | (20 )                          | (34 ) | 0                              | 0     |
| Amortization of prior service cost      | 0                              | 0     | (23 )                          | (22 ) |
| Recognized net actuarial loss           | 8                              | 11    | 0                              | 0     |
| Net periodic benefit cost               | \$ 8                           | \$ 4  | \$ 51                          | \$ 49 |

| Defined Benefit Plans<br>(In Thousands) | Pension                         |       | Postretirement                  |       |
|---|---------------------------------|-------|---------------------------------|-------|
|   | Three Months Ended<br>Sept. 30, |       | Three Months Ended<br>Sept. 30, |       |
|   | 2016                            | 2015  | 2016                            | 2015  |
| Service cost                            | \$ 0                            | \$ 0  | \$ 9                            | \$ 10 |
| Interest cost                           | 7                               | 9     | 16                              | 14    |
| Expected return on plan assets          | (7 )                            | (11 ) | 0                               | 0     |

|                                    |      |      |       |       |
|------------------------------------|------|------|-------|-------|
| Amortization of prior service cost | 0    | 0    | (8 )  | (7 )  |
| Recognized net actuarial loss      | 3    | 4    | 0     | 0     |
| Net periodic benefit cost          | \$ 3 | \$ 2 | \$ 17 | \$ 17 |

In the first nine months of 2016, the Corporation funded postretirement contributions totaling \$44,000, with estimated annual postretirement contributions of \$68,000 expected in 2016 for the full year. Based upon the related actuarial reports, no defined benefit pension contributions are required in 2016, though the Corporation may make discretionary contributions.

## 10. STOCK-BASED COMPENSATION PLANS

The Corporation has a Stock Incentive Plan for a selected group of officers and an Independent Directors Stock Incentive Plan. In the three-month periods ended March 31, 2016 and 2015, the Corporation issued restricted stock under each of the Plans.

In the first quarter 2016, the Corporation awarded a total of 34,199 shares of restricted stock under the Stock Incentive and Independent Directors Stock Incentive Plans. Restricted stock awards in the first quarter 2016 included the following: (1) a total of 17,289 shares to employees, vesting over a three-year term, with vesting contingent upon the Corporation meeting an annual return on average equity (“ROAE”) performance ratio, as defined; (2) a total of 10,304 shares to employees, vesting over a three-year term, with vesting dependent on satisfactory performance; and (3) a total of 6,606 shares under the Independent Directors Incentive Plan, vesting over a term of one year.

In the second quarter 2016, the Corporation awarded a total of 1,228 shares of restricted stock under the Independent Directors Stock Incentive Plan. The restricted stock was awarded to two new directors, with each award vesting over a term of one year.

In the first quarter 2015, a total of 34,800 shares of restricted stock were awarded under the Plans. Restricted stock awards in 2015 included the following: (1) a total of 20,298 shares to employees, vesting over a four-year term, with vesting contingent upon the Corporation meeting an annual ROAE performance ratio, as defined; (2) a total of 2,198 shares to employees, vesting over a four-year term, with vesting dependent on satisfactory performance; (3) an award to the Chief Executive Officer of 5,174 shares, vesting over a three-year term, with vesting dependent on satisfactory performance; and (4) a total of 7,130 shares under the Independent Directors Incentive Plan, vesting over a term of one year.

Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. Management has estimated restricted stock expense in the first nine months of 2016 based on an assumption that the ROAE target for 2016 will be met.

Total stock-based compensation expense is as follows:

| (In Thousands)   | 3 Months Ended       |                   | 9 Months Ended       |                   |
|------------------|----------------------|-------------------|----------------------|-------------------|
|                  | Sept.<br>30,<br>2016 | Sept. 30,<br>2015 | Sept.<br>30,<br>2016 | Sept. 30,<br>2015 |
| Restricted stock | \$ 155               | \$ 152            | \$ 480               | \$ 459            |

## 11. INCOME TAXES

The net deferred tax asset at September 30, 2016 and December 31, 2015 represents the following temporary difference components:

| (In Thousands)                         | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| Deferred tax assets:                   |                       |                      |
| Net realized losses on securities      | 36                    | \$ 69                |
| Allowance for loan losses              | 2,980                 | 2,761                |
| Other deferred tax assets              | 2,517                 | 2,634                |
| Total deferred tax assets              | 5,533                 | 5,464                |
| Deferred tax liabilities:              |                       |                      |
| Unrealized holding gains on securities | 2,902                 | 1,342                |
| Defined benefit plans - ASC 835        | 23                    | 19                   |

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|                                |          |          |
|--------------------------------|----------|----------|
| Bank premises and equipment    | 952      | 869      |
| Core deposit intangibles       | 7        | 11       |
| Other deferred tax liabilities | 105      | 108      |
| Total deferred tax liabilities | 3,989    | 2,349    |
| Deferred tax asset, net        | \$ 1,544 | \$ 3,115 |

The provision for income tax for the three-month and nine-month periods ended September 30, 2016 and 2015 is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The effective tax rates for the Corporation are as follows:

| (In thousands)                     | 3 Months Ended |         | 9 Months Ended |          |
|------------------------------------|----------------|---------|----------------|----------|
|                                    | September 30,  |         | September 30,  |          |
|                                    | 2016           | 2015    | 2016           | 2015     |
| Income before income tax provision | \$5,538        | \$5,629 | \$15,378       | \$16,482 |
| Income tax provision               | 1,451          | 1,395   | 3,847          | 4,076    |
| Effective tax rate                 | 26.20%         | 24.78%  | 25.02 %        | 24.73 %  |

The effective tax rate for each period presented differs from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation has investments in three limited partnerships that manage affordable housing projects that have qualified for the federal low-income housing tax credit. The Corporation's expected return from these investments is based on the receipt of tax credits and tax benefits from deductions of operating losses. The Corporation uses the effective yield method to account for these investments, with the benefits recognized as a reduction of the provision for income taxes. For two of the three limited partnership investments, the tax credits have been received in full in prior years, and the Corporation has fully realized the benefits of the credits and amortized its initial investments in the partnerships. The most recent affordable housing project was completed in 2013, and the Corporation received tax credits in 2013, 2014 and 2015 and expects to continue to receive tax credits annually through 2022. The carrying amount of the Corporation's investment is \$737,000 at September 30, 2016 and \$812,000 at December 31, 2015 (included in Other Assets in the consolidated balance sheets). For the year ending December 31, 2016, the estimated amount of tax credits and other tax benefits to be received is \$158,000 and the estimated amount to be recognized as a reduction of the provision for income taxes is \$76,000. For the year ended December 31, 2015, tax credits and other tax benefits totaled \$158,000 and the amount recognized as a reduction of the provision for income taxes for 2015 was \$80,000. The total reduction in the provision for income taxes resulting from this investment is \$19,000 in the third quarter 2016, and \$57,000 for the nine months ended September 30, 2016, and \$22,000 in the third quarter 2015, and \$62,000 for the nine months ended September 30, 2015.

The Corporation has no unrecognized tax benefits, nor pending examination issues related to tax positions taken in preparation of its income tax returns. With limited exceptions, the Corporation is no longer subject to examination by the Internal Revenue Service for years prior to 2013.

## **12. CONTINGENCIES**

In the normal course of business, the Corporation may be subject to pending and threatened lawsuits in which claims for monetary damages could be asserted. In management's opinion, the Corporation's financial position and results of operations would not be materially affected by the outcome of such pending legal proceedings.

## **13. RECENT ACCOUNTING PRONOUNCEMENTS**

The FASB issues Accounting Standards Updates (ASUs) to the FASB ASC. This section provides a summary description of recent ASUs that have significant implications (elected or required) within the consolidated financial statements, or that management expects may have a significant impact on financial statements issued in the near future.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which provides a principles-based framework for revenue recognition that supersedes virtually all previously issued revenue recognition guidance under U.S. GAAP. Additionally, the ASU requires improved disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue that is recognized. The core principle of the five-step revenue recognition framework is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In April 2016, the FASB issued ASU 2016-10, which provides clarifying information related to identifying performance obligations and licensing. In May 2016, the FASB issued ASU 2016-12, which provides clarifying guidance in a few narrow areas and adds some practical expedients to the guidance. In August 2015 the FASB issued ASU 2015-14, which deferred the effective date of the revenue recognition standard by a year, making it applicable for the Corporation in the first quarter 2018 and for the annual period ending December 31, 2018. The amendments should be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the amendments recognized at the date of initial application. The Corporation is in the process of evaluating the potential impact of adopting the amendments, including determining which transition method to apply.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Liabilities. This makes significant changes in U.S. GAAP related to certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The changes provided for in this Update that are applicable to the Corporation are as follows: (1) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; however, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) for equity investments without readily determinable fair values, require a qualitative assessment to identify impairment, and if a qualitative assessment indicates that impairment exists, requiring an entity to measure the investment at fair value; (3) eliminate the requirement for public business entities to disclose the method(s) 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; (4) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) require 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 (at September 30, 2016 and December 31, 2015, the Corporation has no liabilities for which the fair value measurement option has been elected); (6) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (7) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The amendments in this Update will become effective for the Corporation for annual and interim periods beginning in the first quarter 2018. With limited exceptions, early adoption of the amendments in this Update is not permitted. Amendments are to be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values should be applied prospectively.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. Specifically, a lessee should recognize on the balance sheet a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee would be permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and liabilities. Topic 842 would not significantly change the recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee from current U.S. GAAP; however, the principal change from current GAAP is that lease assets and liabilities arising from operating leases would be recognized on the balance sheet. Topic 842 provides several other changes or clarifications to existing GAAP, and will require qualitative disclosures, along with quantitative disclosures, so that financial statement users can understand more about the nature of an entity's leasing activities. In transition, Topic 842 provides that lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, including optional practical expedients. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees will be required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP. Topic 842 will become effective for the Corporation for annual and interim periods beginning in the first quarter 2019.

In March 2016, the FASB issued ASU No. 2016-07, Investments – Equity Method and Joint Ventures. This ASU eliminates the requirement that when an investment qualifies for the equity method as a result of an increase in the level of ownership interest or influence, an investor must adjust the investment, results of operations and retained earnings retroactively as if the equity method had been in effect during all previous periods the investment had been held. The ASU requires the equity method investor to add the cost of acquiring an additional interest in the investee to the basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for the equity method. The ASU further requires that an entity that has an available-for-sale equity security that becomes qualified for the equity method recognize through earnings the unrealized gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments in this Update are effective for the Corporation for annual and interim periods beginning in the first quarter 2017, with earlier application permitted. The amendments should be applied prospectively upon their effective date.

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation. This ASU changes several aspects of accounting for share-based payment transactions, and includes some changes that apply only to nonpublic companies. This Update includes amendments that currently apply, or may apply in the future, to the Corporation related to the following: (1) accounting for the difference between the deduction for tax purposes and the amount of compensation cost recognized for financial reporting purposes; (2) classification of excess tax benefits on the statement of cash flows; (3) accounting for forfeitures; (4) accounting for awards partially settled in cash in excess of the employer's minimum statutory tax withholding requirements; and (5) classification of employee taxes paid on the statement of cash flows when an employer withholds shares for tax-withholding purposes. The amendments in this Update are effective for the Corporation for annual and interim periods beginning in the first quarter 2017, with earlier adoption permitted. The ASU provides separate transition provisions for each of the amendments. The Corporation is in the process of evaluating the potential impact of adopting the amendments.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments-Credit Losses (Topic 326). This ASU will result in significant changes in the Corporation's accounting for credit losses related to loans receivable and investment securities. A summary of significant provisions of this ASU is as follows:

The ASU requires that a financial asset (or a group of financial assets) measured at amortized cost basis be presented, net of a valuation allowance for credit losses, at an amount expected to be collected on the financial asset(s), and that the income statement include the measurement of credit losses for newly recognized financial assets as well as changes in expected losses on previously recognized financial assets. The provisions of this ASU require measurement of expected credit losses based on relevant information including past events, historical experience, current conditions, and reasonable and supportive forecasts that affect the collectability of the asset. The provisions of this ASU differ from current U.S. GAAP in that current U.S. GAAP generally delays recognition of the full amount of credit losses until the loss is probable of occurring.

The amendments in the Update retain many of the disclosure requirements related to credit quality in current U.S. GAAP, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. In addition, the Update requires that disclosure of credit quality indicators in relation to the amortized cost of financing receivables, a current requirement, be further disaggregated by year of origination.

This ASU requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down, and limits the amount of the allowance for credit losses to the amount by which the fair value is below amortized cost. For purchased available-for-sale securities with a more-than-insignificant amount of credit deterioration since origination, the ASU requires an allowance be determined in a manner similar to other available-for-sale debt securities; however, the initial allowance would be added to the purchase price, with only subsequent changes in the allowance recorded in credit loss expense, and interest income recognized at the effective rate excluding the discount embedded in the purchase price related to estimated credit losses at acquisition.

This ASU will be effective for the Corporation for interim and annual periods beginning in the first quarter of 2020. Earlier adoption is permitted beginning in the first quarter of 2019. The entity will record the effect of implementing this ASU through a cumulative-effect adjustment through retained earnings as of the beginning of the reporting period in which Topic 326 is effective. The Corporation is in the early stages of evaluating the potential impact of adopting this amendment.

In June 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230) –Classification of Certain Cash Receipts and Cash Payments. This Update provides clarification regarding eight specific cash flow issues with the objective of reducing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. For the Corporation, the amendments in this Update are effective beginning in the first quarter 2018. The amendments in this Update should be applied using a retroactive transition method to each period presented. The Corporation anticipates there will be no adjustments to the Consolidated Statements of Cash Flows, as previously reported, as a result of the clarifications provided in the Update.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements in this section and elsewhere in this quarterly report on Form 10-Q are forward-looking statements. Citizens & Northern Corporation and its wholly-owned subsidiaries (collectively, the Corporation) intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Reform Act of 1995. Forward-looking statements, which are not historical facts, are based on certain assumptions and describe future plans, business objectives and expectations, and are generally identifiable by the use of words such as, "should", "likely", "expect", "plan", "anticipate", "target", "forecast", and "goal". These forward-looking statements are subject to risks and uncertainties that are difficult to predict, may be beyond management's control and could cause results to differ materially from those expressed or implied by such forward-looking statements. Factors which could have a material, adverse impact on the operations and future prospects of the Corporation include, but are not limited to, the following:

- changes in monetary and fiscal policies of the Federal Reserve Board and the U. S. Government, particularly related to changes in interest rates
- changes in general economic conditions
- legislative or regulatory changes
- downturn in demand for loan, deposit and other financial services in the Corporation's market area
- increased competition from other banks and non-bank providers of financial services
- technological changes and increased technology-related costs
- changes in accounting principles, or the application of generally accepted accounting principles.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

### **EARNINGS OVERVIEW**

Third quarter 2016 net income was \$0.34 per basic and diluted share, as compared to \$0.32 in the second quarter 2016 and \$0.35 in the third quarter 2015. For the nine months ended September 30, 2016, net income per basic and diluted share was \$0.95 as compared to \$1.02 per basic and \$1.01 per diluted share for the first nine months of 2015. The return on average assets for the first nine months of 2016 was 1.25%, and the return on average equity was 8.16%.

Some of the more significant fluctuations in revenues and expenses between the three-month period ended September 30, 2016 and the corresponding period in 2015 were as follows:

Net interest income increased \$179,000 (1.8%), in the third quarter 2016 as compared to the third quarter 2015. The net interest margin for the third quarter 2016 was 0.08% higher than in the third quarter 2015 due to a lower cost of borrowed funds and a more favorable mix of earning assets. The average balance of total borrowed funds was \$57,226,000 at an average interest rate of 2.75% in the third quarter 2016, down from average borrowings of \$75,848,000 at an average interest rate of 3.34% in the third quarter 2015. The reduction in amount and average rate on borrowed funds reflects the impact of prepayments in the second and fourth quarters of 2015 of a long-term borrowing with an interest rate of 4.265%. Average total loans outstanding were higher by \$59.3 million (8.8%) in the third quarter 2016 as compared to the third quarter 2015, while average total available-for-sale securities were lower by \$68.7 million. Average total deposits were \$6.0 million (0.6%) higher in the third quarter 2016 as compared to the third quarter 2015.

The third quarter 2016 provision for loan losses was \$236,000 higher than the comparative third quarter 2015 amount. The higher provision in the third quarter 2016 included the impact of an increase in specific allowances on impaired loans to \$685,000 at September 30, 2016 from \$253,000 at June 30, 2016, including the effect of recording an allowance of \$528,000 in the third quarter 2016 related to one real estate secured commercial loan relationship with total loans outstanding of \$3,347,000 at September 30, 2016.

Noninterest revenue in the third quarter 2016 fell \$77,000 (1.9%) from the third quarter 2015 amount. Service charges on deposit accounts were \$81,000 (6.2%) lower, reflecting a reduced volume of consumer overdrafts, and the fair value of mortgage servicing rights decreased \$68,000 in the third quarter 2016 compared to an increase in fair value of \$13,000 in the third quarter 2015. Trust and Financial Management revenue increased \$49,000 (4.4%) in the third quarter 2016 as compared to the third quarter 2015. Other operating income was \$58,000 higher in the third quarter 2016 as compared to the third quarter 2015, including an increase of \$15,000 in dividend income from Federal Home Loan Bank of Pittsburgh stock.

Realized gains from securities totaled \$584,000 in the third quarter 2016, including gains of \$560,000 from sales of bank stocks. In comparison, realized gains from securities totaled \$79,000 in the third quarter 2015. At September 30, 2016, the Corporation had one remaining bank stock investment, with an amortized cost basis of \$752,000 and a fair value of \$1,080,000. In October 2016, the Corporation sold the stock for a realized gain (pre-tax) of \$288,000.

Noninterest expenses in the third quarter 2016 exceeded the third quarter 2015 amount by \$462,000 (5.7%). Salaries and wages expense increased \$157,000 (4.2%), reflecting an increase in number of employees, including new positions established for lending, lending support, information technology, training, human resources and marketing functions. Professional fees expense increased \$104,000 in the third quarter 2016 over the third quarter 2015 amount, including increases related to employee sales and service training, information technology, marketing and outsourced commercial loan credit review. Other operating expense increased \$164,000 (13.6%) in the third quarter 2016 over the third quarter 2015, including increases in education and training-related expense of \$29,000, net collection-related expenses of \$29,000 and expenses related to other real estate properties of \$27,000. Also, other operating expense in the third quarter 2015 was reduced by a refund of \$69,000 from recovery of previously-paid sales tax, with no corresponding recovery in the third quarter 2016.

The third quarter 2016 provision for income tax of \$1,451,000, or 26.2% of pre-tax income, was \$56,000 higher than the third quarter 2015 tax provision of \$1,395,000, or 24.8% of pre-tax income. The higher effective tax in the third quarter 2016 included the effects of a reduction in tax-exempt interest income of \$127,000. The reduction in tax-exempt interest income resulted from pay-offs received on municipal bonds purchased several years ago when market interest yields were higher. Also, the provision for state income tax was \$39,000 higher, primarily as a result of a catch-up adjustment to increase New York State taxes for the effect of changes in the tax methodology that first became effective in 2015.

Some of the more significant fluctuations in revenues and expenses between the nine-month period ended September 30, 2016 and the corresponding period in 2015 were as follows:

Net interest income was \$251,000 (0.8%) higher than the comparable total for the first nine months of 2015. The net interest margin of 3.77% was 0.08% higher than the margin for the first nine months of 2015, reflecting a lower cost of borrowed funds resulting from prepayment in 2015 of a long-term borrowing and a more favorable mix of earning assets. The average balance of total borrowed funds was \$64,476,000 at an average interest rate of 2.53% for the first nine months of 2016, down from average borrowings of \$77,749,000 at an average interest rate of 3.55% in the first nine months of 2015. Average total loans outstanding were higher by \$68.9 million (10.7%) in the first nine months of 2016 as compared to the first nine months of 2015, while average total available-for-sale securities were lower by \$87.6 million. The average balance of earning assets was \$20.6 million lower in the nine-month period ended September 30, 2016 as compared to the first nine months of 2015, reflecting a reduction in funding available for investment, including a decrease in average total deposits of \$9.3 million (1.0%).

The provision for loan losses for the nine months ended September 30, 2016 totaled \$1,224,000, an increase of \$698,000 over the corresponding amount for the first nine months of 2015. In 2016, the provision included an increase of \$418,000 as compared to the first nine months of 2015 from changes in specific allowances on loans

individually identified as impaired, adjusted for the impact of net charge-offs. The provision in 2016 also included the impact of increasing the allowance for loan losses for the effects of loan growth and slight increases in net charge-off experience and qualitative factors used in determining the collectively evaluated portion of the allowance. In comparison, the provision in 2015 also reflected the effects of loan growth, but the qualitative factors used in determining a portion of the collectively determined allowance for loan losses were slightly decreased during the period.

Total noninterest revenue for the nine months ended September 30, 2016 was virtually unchanged from the corresponding amount for the first nine months of 2015. Within noninterest income, the categories with the largest increases included: (1) other operating income, which increased \$157,000, mainly due to an increase in revenue from redemption of tax credits; (2) net gains from sales of loans, which increased \$126,000 (22.0%), reflecting higher volume of sales; and (3) Trust and Financial Management revenue, which increased \$89,000 (2.6%). The categories with the largest decreases within noninterest revenue included: (1) decrease in fair value of mortgage servicing rights of \$247,000 in the first nine months of 2016 as compared to a decrease in fair value of \$137,000 in the first nine months of 2015; (2) decrease in service charges on deposit accounts of \$106,000 (2.9%), reflecting a reduction in consumer overdraft volume; and (3) reduction in brokerage revenue of \$71,000, as the volume of sales of annuities declined.

In the first nine months of 2016, realized gains from securities totaled \$1,089,000, including gains from sales of bank stocks of \$837,000. In the first nine months of 2015, the Corporation generated gains from sales of securities totaling \$1,085,000, including gains from sales of bank stocks of \$476,000, and also incurred a loss from prepayment of a borrowing of \$910,000. In the second quarter 2015, the Corporation prepaid principal of \$10 million on a long-term borrowing (repurchase agreement) with an interest rate of 4.265%.

Noninterest expenses, excluding loss on prepayment of borrowings, in the first nine months of 2016 exceeded the amount for the first nine months of 2015 by \$1,572,000 (6.4%). Salaries and wages expense increased \$867,000 (8.0%). As described above, several new positions were established in the latter portion of 2015 and early 2016. Professional fees expense increased \$379,000, including increases related to employee sales and service training, information technology, marketing and outsourced commercial loan credit review. Other operating expense increased \$311,000 (8.0%), including increases in donations and public relations-related expenses of \$90,000, education and training-related expenses of \$86,000 and other real estate expenses of \$48,000. Also, other operating expense was reduced in 2015 by \$69,000 as a result of a recovery of sales tax previously paid. Within other operating expense, net collections-related expense was \$59,000 lower in the first nine months of 2016 as compared to the corresponding period in 2015.

The provision for income tax totaled \$3,847,000 for the nine months ended September 30, 2016, down \$229,000 from the amount for the first nine months of 2015. The lower tax provision in 2016 resulted from lower pre-tax income; however, the provision increased as a percentage of pre-tax income to 25.02% in 2016 from 24.73% in 2015. The higher effective tax rate included the impact of a \$253,000 reduction in tax-exempt interest income and an increase in the provision for state income tax of \$30,000 that resulted mainly from a catch-up adjustment to increase New York State taxes for the effect of changes in the tax methodology that first became effective in 2015.

More detailed information concerning fluctuations in the Corporation's earnings results and other financial information are provided in other sections of Management's Discussion and Analysis.

## TABLE I - QUARTERLY FINANCIAL DATA

(In Thousands) (Unaudited)

|                           | For the Three Months Ended: |                  |                  |                  |                   |                  |                  |
|---------------------------|-----------------------------|------------------|------------------|------------------|-------------------|------------------|------------------|
|                           | Sept. 30,<br>2016           | June 30,<br>2016 | Mar. 31,<br>2016 | Dec. 31,<br>2015 | Sept. 30,<br>2015 | June 30,<br>2015 | Mar. 31,<br>2015 |
| Interest income           | \$ 11,131                   | \$ 10,924        | \$ 10,937        | \$ 11,036        | \$ 11,134         | \$ 11,186        | \$ 11,163        |
| Interest expense          | 944                         | 925              | 904              | 1,087            | 1,126             | 1,176            | 1,213            |
| Net interest income       | 10,187                      | 9,999            | 10,033           | 9,949            | 10,008            | 10,010           | 9,950            |
| Provision for loan losses | 538                         | 318              | 368              | 319              | 302               | 221              | 3                |
|                           | 9,649                       | 9,681            | 9,665            | 9,630            | 9,706             | 9,789            | 9,947            |

|   |         |         |         |         |         |         |         |
|---|---------|---------|---------|---------|---------|---------|---------|
| Net interest income after provision for loan losses |         |         |         |         |         |         |         |
| Other income  | 3,884   | 3,906   | 3,690   | 3,999   | 3,961   | 3,962   | 3,556   |
| Net gains on available-for-sale securities          | 584     | 122     | 383     | 1,776   | 79      | 932     | 74      |
| Loss on prepayment of borrowings                    | 0       | 0       | 0       | 1,663   | 0       | 910     | 0       |
| Other expenses                                      | 8,579   | 8,535   | 9,072   | 8,416   | 8,117   | 7,964   | 8,533   |
| Income before income tax provision                  | 5,538   | 5,174   | 4,666   | 5,326   | 5,629   | 5,809   | 5,044   |
| Income tax provision                                | 1,451   | 1,303   | 1,093   | 1,261   | 1,395   | 1,452   | 1,229   |
| Net income  | \$4,087 | \$3,871 | \$3,573 | \$4,065 | \$4,234 | \$4,357 | \$3,815 |
| Net income per share – basic                        | \$0.34  | \$0.32  | \$0.29  | \$0.33  | \$0.35  | \$0.36  | \$0.31  |
| Net income per share – diluted                      | \$0.34  | \$0.32  | \$0.29  | \$0.33  | \$0.35  | \$0.36  | \$0.31  |

## CRITICAL ACCOUNTING POLICIES

The presentation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect many of the reported amounts and disclosures. Actual results could differ from these estimates.

A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses. Management believes the allowance for loan losses is adequate and reasonable. Analytical information related to the Corporation's aggregate loans and the related allowance for loan losses is summarized by loan segment and classes of loans in Note 7 to the unaudited consolidated financial statements. Additional discussion of the Corporation's allowance for loan losses is provided in a separate section later in Management's Discussion and Analysis. Given the very subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Corporation's debt securities. For most of the Corporation's debt securities, the Corporation receives estimated fair values of debt securities from an independent valuation service, or from brokers. In developing fair values, the valuation service and the brokers use estimates of cash flows, based on historical performance of similar instruments in similar interest rate environments. Based on experience, management is aware that estimated fair values of debt securities tend to vary among brokers and other valuation services.

As described in Note 6 to the unaudited consolidated financial statements, management evaluates securities for other-than-temporary impairment (OTTI). In making that evaluation, consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security or more likely than not will be required to sell the security before its anticipated recovery. Management's assessments of the likelihood and potential for recovery in value of securities are subjective and based on sensitive assumptions.

## **NET INTEREST INCOME**

The Corporation's primary source of operating income is net interest income, which is equal to the difference between the amounts of interest income and interest expense. Tables II, III and IV include information regarding the Corporation's net interest income for the three-month and nine-month periods ended September 30, 2016 and September 30, 2015. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest income amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the related Tables.

### **Nine-Month Periods Ended September 30, 2016 and 2015**

For the nine-month periods, fully taxable equivalent net interest income was \$32,297,000 in 2016, \$125,000 (0.4%) higher than in 2015. Interest income was \$617,000 lower in 2016 as compared to 2015; however, interest expense was lower by \$742,000 in comparing the same periods. As presented in Table III, the Net Interest Margin was 3.77% in 2016 as compared to 3.69% in 2015, and the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.64% in 2016 as compared to 3.54% in 2015.

## **INTEREST INCOME AND EARNING ASSETS**

Interest income totaled \$35,070,000 in 2016, a decrease of 1.7% from 2015. Interest and fees on loans receivable increased \$1,320,000, or 5.2%. The average balance of gross loans receivable increased \$68,937,000, or 10.7%, to \$715,575,000 in 2016 from \$646,638,000 in 2015. The Corporation experienced significant growth in both commercial and mortgage loans outstanding. Growth in commercial loans included an increase of approximately \$23.3 million in the average outstanding balance of participation loans in the first nine months of 2016 as compared to the first nine months of 2015. The Corporation's average rate of return on loans receivable declined to 4.94% in 2016 from 5.20% in 2015 as average interest rates on new loans are lower, reflecting recent market conditions.

As indicated in Table III, average available-for-sale securities (at amortized cost) totaled \$407,347,000 in 2016, a decrease of \$87,574,000 (17.7%) from 2015. The net decrease in the Corporation's available-for-sale securities portfolio consisted of decreases in all categories of securities with the exception of commercial mortgage-backed securities. The Corporation's yield on securities was slightly lower in 2016 than in 2015, primarily because of lower market interest rates. The average rate of return on available-for-sale securities was 2.78% in 2016 and 2.82% in 2015.

#### INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell \$742,000, or 21.1%, to \$2,773,000 in 2016 from \$3,515,000 in 2015. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 0.45% in 2016 from 0.56% in 2015.

Total average deposits (interest-bearing and noninterest-bearing) decreased 1.0%, to \$965,584,000 in 2016 from \$974,873,000 in 2015. Decreases in the average balances of Individual Retirement Accounts, certificates of deposit and demand deposits were partially offset by increases in savings, interest checking and money market accounts.

Total average borrowed funds decreased \$13,273,000 to \$64,476,000 in 2016 from \$77,749,000 in 2015. The average rate on borrowed funds was 2.53% in 2016 compared to 3.55% in 2015, reflecting a \$29,684,000 reduction in the average balance of higher-rate, long-term borrowings resulting from prepayment in the second and fourth quarters of 2015 of a long-term repurchase agreement borrowing with an interest rate of 4.265%. The average balance of short-term borrowings increased \$16,411,000 in 2016 over 2015, as average overnight borrowings were higher in 2016 and the Corporation funded the pay-off of the long-term repurchase agreement with a series of short-term advances from the FHLB-Pittsburgh.

### **Three-Month Periods Ended September 30, 2016 and 2015**

For the three-month periods, fully taxable equivalent net interest income was \$10,869,000 in 2016, which was \$114,000 (1.1%) higher than in 2015. Interest income was \$68,000 lower in 2016 as compared to 2015, while interest expense was lower by \$182,000 in comparing the same periods. As presented in Table III, the Net Interest Margin was 3.74% in 2016 as compared to 3.66% in 2015, and the “Interest Rate Spread” (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.61% in 2016 as compared to 3.51% in 2015.

Interest income totaled \$11,813,000 in 2016, a decrease of \$68,000 (0.6%) from 2015. Interest and fees from loans receivable increased \$476,000, or 5.6%, in 2016 as compared to 2015, while income from available-for-sale securities decreased \$553,000 (16.8%). As indicated in Table III, for the three-month periods, the average balance of gross loans receivable increased 8.8% to \$733,016,000 in 2016 from \$673,735,000 in 2015. The average rate of return on loans was 4.91% in 2016, down from 5.05% in 2015. Total average available-for-sale securities (at amortized cost) in 2016 decreased

to \$404,526,000 from \$473,216,000 in 2015. The average rate of return on available-for-sale securities was 2.69% for 2016, down from 2.75% in 2015.

For the three-month periods, interest expense fell \$182,000, or 16.2%, to \$944,000 in 2016 from \$1,126,000 in 2015. Total average deposits (interest-bearing and noninterest-bearing) amounted to \$983,353,000 in the third quarter 2016, an increase of \$6,036,000 (0.6%) from the third quarter 2015 total. Total average borrowed funds decreased to \$57,226,000 in the third quarter 2016 from \$75,848,000 in the third quarter 2015, while the average rate on borrowed funds fell to 2.75% in the third quarter 2016 from 3.34% in the third quarter 2015. The net change in average borrowed funds included an increase of \$5,683,000 in short-term borrowings and a decrease of \$24,305,000 in long-term borrowings. In total, the average interest rate on interest-bearing liabilities was 0.46% in the third quarter 2016 as compared to 0.53% in the third quarter 2015. The reduction in average rate on interest-bearing liabilities in 2016 was mainly caused by the pay-off (prepayment) of the higher-cost borrowing in 2015, as described above.



**TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE**

| (In Thousands)                      | Three Months Ended |           |                         | Nine Months Ended |           |                         |
|-------------------------------------|--------------------|-----------|-------------------------|-------------------|-----------|-------------------------|
|                                     | Sept. 30,<br>2016  | 2015      | Increase/<br>(Decrease) | Sept. 30,<br>2016 | 2015      | Increase/<br>(Decrease) |
| <b>INTEREST INCOME</b>              |                    |           |                         |                   |           |                         |
| Available-for-sale securities:      |                    |           |                         |                   |           |                         |
| Taxable                             | \$ 1,456           | \$ 1,837  | \$ (381 )               | \$ 4,540          | \$ 5,899  | \$ (1,359 )             |
| Tax-exempt                          | 1,277              | 1,449     | (172 )                  | 3,941             | 4,546     | (605 )                  |
| Total available-for-sale securities | 2,733              | 3,286     | (553 )                  | 8,481             | 10,445    | (1,964 )                |
| Interest-bearing due from banks     | 29                 | 22        | 7                       | 89                | 73        | 16                      |
| Loans held for sale                 | 7                  | 5         | 2                       | 21                | 10        | 11                      |
| Loans receivable:                   |                    |           |                         |                   |           |                         |
| Taxable                             | 8,347              | 7,851     | 496                     | 24,407            | 23,313    | 1,094                   |
| Tax-exempt                          | 697                | 717       | (20 )                   | 2,072             | 1,846     | 226                     |
| Total loans receivable              | 9,044              | 8,568     | 476                     | 26,479            | 25,159    | 1,320                   |
| Total Interest Income               | 11,813             | 11,881    | (68 )                   | 35,070            | 35,687    | (617 )                  |
| <b>INTEREST EXPENSE</b>             |                    |           |                         |                   |           |                         |
| Interest-bearing deposits:          |                    |           |                         |                   |           |                         |
| Interest checking                   | 78                 | 53        | 25                      | 210               | 162       | 48                      |
| Money market                        | 89                 | 77        | 12                      | 254               | 222       | 32                      |
| Savings                             | 34                 | 32        | 2                       | 99                | 96        | 3                       |
| Certificates of deposit             | 238                | 211       | 27                      | 660               | 631       | 29                      |
| Individual Retirement Accounts      | 109                | 113       | (4 )                    | 326               | 340       | (14 )                   |
| Other time deposits                 | 1                  | 1         | 0                       | 1                 | 1         | 0                       |
| Total interest-bearing deposits     | 549                | 487       | 62                      | 1,550             | 1,452     | 98                      |
| Borrowed funds:                     |                    |           |                         |                   |           |                         |
| Short-term                          | 30                 | 9         | 21                      | 133               | 15        | 118                     |
| Long-term                           | 365                | 630       | (265 )                  | 1,090             | 2,048     | (958 )                  |
| Total borrowed funds                | 395                | 639       | (244 )                  | 1,223             | 2,063     | (840 )                  |
| Total Interest Expense              | 944                | 1,126     | (182 )                  | 2,773             | 3,515     | (742 )                  |
| Net Interest Income                 | \$ 10,869          | \$ 10,755 | \$ 114                  | \$ 32,297         | \$ 32,172 | \$ 125                  |

Note: Interest income from tax-exempt securities and loans has been adjusted to a fully tax-equivalent basis, using the Corporation's marginal federal income tax rate of 35%.

**TABLE III - ANALYSIS OF AVERAGE DAILY BALANCES AND RATES****(Dollars in Thousands)**

|   | 3 Months<br>Ended<br>9/30/2016<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 3 Months<br>Ended<br>9/30/2015<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 9 Months<br>Ended<br>9/30/2016<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 9 Months<br>Ended<br>9/30/2015<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% |
|---|--|---|--|---|--|---|--|---|
| <b>EARNING ASSETS</b>                             |  |   |  |   |  |   |  |   |
| Available-for-sale securities, at amortized cost: |  |   |  |   |  |   |  |   |
| Taxable   | \$291,847  | 1.98 %  | \$361,481  | 2.02 %  | \$298,421  | 2.03 %  | \$379,666  | 2.08 %  |
| Tax-exempt  | 112,679  | 4.51 %  | 111,735  | 5.14 %  | 108,926  | 4.83 %  | 115,255  | 5.27 %  |
| Total available-for-sale securities               | 404,526  | 2.69 %  | 473,216  | 2.75 %  | 407,347  | 2.78 %  | 494,921  | 2.82 %  |
| Interest-bearing due from banks                   | 17,138   | 0.67 %  | 19,774   | 0.44 %  | 20,566   | 0.58 %  | 22,886   | 0.43 %  |
| Loans held for sale                               | 556  | 5.01 %  | 245  | 8.10 %  | 516  | 5.44 %  | 160  | 8.36 %  |
| Loans receivable:                                 |  |   |  |   |  |   |  |   |
| Taxable   | 671,408  | 4.95 %  | 610,516  | 5.10 %  | 654,256  | 4.98 %  | 595,170  | 5.24 %  |
| Tax-exempt  | 61,608   | 4.50 %  | 63,219   | 4.50 %  | 61,319   | 4.51 %  | 51,468   | 4.80 %  |
| Total loans receivable                            | 733,016  | 4.91 %  | 673,735  | 5.05 %  | 715,575  | 4.94 %  | 646,638  | 5.20 %  |
| Total Earning Assets                              | 1,155,236  | 4.07 %  | 1,166,970  | 4.04 %  | 1,144,004  | 4.09 %  | 1,164,605  | 4.10 %  |
| Cash  | 17,523   |   | 16,961   |   | 16,548   |   | 16,723   |   |
| Unrealized gain/loss on securities                | 9,654  |   | 7,015  |   | 8,154  |   | 9,287  |   |
| Allowance for loan losses                         | (8,050 )   |   | (7,376 )   |   | (7,913 )   |   | (7,331 )   |   |
| Bank premises and equipment                       | 15,379   |   | 15,808   |   | 15,409   |   | 16,050   |   |
| Intangible Asset - Core Deposit Intangible        | 24   |   | 38   |   | 26   |   | 44   |   |
| Intangible Asset - Goodwill                       | 11,942   |   | 11,942   |   | 11,942   |   | 11,942   |   |
| Other assets                                      | 38,225   |   | 38,294   |   | 38,563   |   | 37,836   |   |
| Total Assets                                      | \$1,239,933  |   | \$1,249,652  |   | \$1,226,733  |   | \$1,249,156  |   |

**INTEREST-BEARING LIABILITIES**

Interest-bearing deposits:

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|   |             |        |             |        |             |        |             |        |
|---|-------------|--------|-------------|--------|-------------|--------|-------------|--------|
| Interest checking   | \$200,789   | 0.15 % | \$197,189   | 0.11 % | \$197,628   | 0.14 % | \$196,109   | 0.11 % |
| Money market  | 205,158     | 0.17 % | 202,106     | 0.15 % | 199,211     | 0.17 % | 197,852     | 0.15 % |
| Savings   | 133,269     | 0.10 % | 128,939     | 0.10 % | 131,880     | 0.10 % | 128,561     | 0.10 % |
| Certificates of deposit   | 123,475     | 0.77 % | 125,886     | 0.66 % | 118,256     | 0.75 % | 123,523     | 0.68 % |
| Individual Retirement Accounts                                  | 103,259     | 0.42 % | 109,661     | 0.41 % | 104,280     | 0.42 % | 111,729     | 0.41 % |
| Other time deposits   | 1,523       | 0.26 % | 1,514       | 0.26 % | 1,157       | 0.12 % | 1,150       | 0.12 % |
| Total interest-bearing deposits                                 | 767,473     | 0.28 % | 765,295     | 0.25 % | 752,412     | 0.28 % | 758,924     | 0.26 % |
| Borrowed funds:   |             |        |             |        |             |        |             |        |
| Short-term  | 18,655      | 0.64 % | 12,972      | 0.28 % | 25,828      | 0.69 % | 9,417       | 0.21 % |
| Long-term   | 38,571      | 3.76 % | 62,876      | 3.98 % | 38,648      | 3.77 % | 68,332      | 4.01 % |
| Total borrowed funds  | 57,226      | 2.75 % | 75,848      | 3.34 % | 64,476      | 2.53 % | 77,749      | 3.55 % |
| Total Interest-bearing Liabilities                              | 824,699     | 0.46 % | 841,143     | 0.53 % | 816,888     | 0.45 % | 836,673     | 0.56 % |
| Demand deposits   | 215,880     |        | 212,022     |        | 213,172     |        | 215,949     |        |
| Other liabilities   | 9,057       |        | 8,803       |        | 8,249       |        | 8,229       |        |
| Total Liabilities   | 1,049,636   |        | 1,061,968   |        | 1,038,309   |        | 1,060,851   |        |
| Stockholders' equity, excluding other comprehensive income/loss | 183,966     |        | 183,116     |        | 183,078     |        | 182,252     |        |
| Other comprehensive income/loss                                 | 6,331       |        | 4,568       |        | 5,346       |        | 6,053       |        |
| Total Stockholders' Equity                                      | 190,297     |        | 187,684     |        | 188,424     |        | 188,305     |        |
| Total Liabilities and Stockholders' Equity                      | \$1,239,933 |        | \$1,249,652 |        | \$1,226,733 |        | \$1,249,156 |        |
| Interest Rate Spread  |             | 3.61 % |             | 3.51 % |             | 3.64 % |             | 3.54 % |
| Net Interest Income/Earning Assets                              |             | 3.74 % |             | 3.66 % |             | 3.77 % |             | 3.69 % |
| Total Deposits (Interest-bearing and Demand)                    | \$983,353   |        | \$977,317   |        | \$965,584   |        | \$974,873   |        |

(1) Annualized rates of return on tax-exempt securities and loans are presented on a fully taxable-equivalent basis, using the Corporation's marginal federal income tax rate of 35%.

(2) Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

(3) Rates of return on earning assets and costs of funds are presented on an annualized basis.

**TABLE IV - ANALYSIS OF VOLUME AND RATE CHANGES**

| (In Thousands)                      | 3 Months Ended 9/30/16 vs. 9/30/15 |                |              | 9 Months Ended 9/30/16 vs. 9/30/15 |                |              |
|-------------------------------------|------------------------------------|----------------|--------------|------------------------------------|----------------|--------------|
|                                     | Change in Volume                   | Change in Rate | Total Change | Change in Volume                   | Change in Rate | Total Change |
| <b>EARNING ASSETS</b>               |                                    |                |              |                                    |                |              |
| Available-for-sale securities:      |                                    |                |              |                                    |                |              |
| Taxable                             | \$ (351 )                          | \$ (30 )       | \$ (381 )    | \$ (1,234 )                        | \$ (125 )      | \$ 1,359 )   |
| Tax-exempt                          | 11                                 | (183 )         | (172 )       | (240 )                             | (365 )         | (605 )       |
| Total available-for-sale securities | (340 )                             | (213 )         | (553 )       | (1,474 )                           | (490 )         | (1,964 )     |
| Interest-bearing due from banks     | (3 )                               | 10             | 7            | (8 )                               | 24             | 16           |
| Loans held for sale                 | 3                                  | (1 )           | 2            | 15                                 | (4 )           | 11           |
| Loans receivable:                   |                                    |                |              |                                    |                |              |
| Taxable                             | 748                                | (252 )         | 496          | 2,256                              | (1,162 )       | 1,094        |
| Tax-exempt                          | (24 )                              | 4              | (20 )        | 339                                | (113 )         | 226          |
| Total loans receivable              | 724                                | (248 )         | 476          | 2,595                              | (1,275 )       | 1,320        |
| Total Interest Income               | 384                                | (452 )         | (68 )        | 1,128                              | (1,745 )       | (617 )       |
| <b>INTEREST-BEARING LIABILITIES</b> |                                    |                |              |                                    |                |              |
| Interest-bearing deposits:          |                                    |                |              |                                    |                |              |
| Interest checking                   | 1                                  | 24             | 25           | 1                                  | 47             | 48           |
| Money market                        | 2                                  | 10             | 12           | 2                                  | 30             | 32           |
| Savings                             | 1                                  | 1              | 2            | 2                                  | 1              | 3            |
| Certificates of deposit             | (5 )                               | 32             | 27           | (28 )                              | 57             | 29           |
| Individual Retirement Accounts      | (7 )                               | 3              | (4 )         | (23 )                              | 9              | (14 )        |
| Other time deposits                 | 0                                  | 0              | 0            | 0                                  | 0              | 0            |
| Total interest-bearing deposits     | (8 )                               | 70             | 62           | (46 )                              | 144            | 98           |
| Borrowed funds:                     |                                    |                |              |                                    |                |              |
| Short-term                          | 9                                  | 12             | 21           | 52                                 | 66             | 118          |
| Long-term                           | (233 )                             | (32 )          | (265 )       | (842 )                             | (116 )         | (958 )       |
| Total borrowed funds                | (224 )                             | (20 )          | (244 )       | (790 )                             | (50 )          | (840 )       |
| Total Interest Expense              | (232 )                             | 50             | (182 )       | (836 )                             | 94             | (742 )       |
| Net Interest Income                 | \$ 616                             | \$ (502 )      | \$ 114       | \$ 1,964                           | (\$ 1,839 )    | \$ 125       |

(1) Changes in income on tax-exempt securities and loans are presented on a fully tax-equivalent basis, using the Corporation's marginal federal income tax rate of 35%.

(2) The change in interest due to both volume and rates has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amount of the change in each.



**TABLE V - COMPARISON OF NONINTEREST INCOME****(In Thousands)**

|  | 9 Months Ended |          |           |         |
|--|----------------|----------|-----------|---------|
|  | September 30,  |          | \$        | %       |
|  | 2016           | 2015     | Change    | Change  |
| Service charges on deposit accounts  | \$3,523        | \$3,629  | \$ (106 ) | (2.9 )  |
| Service charges and fees   | 335            | 373      | (38 )     | (10.2 ) |
| Trust and financial management revenue   | 3,567          | 3,478    | 89        | 2.6     |
| Brokerage revenue  | 569            | 640      | (71 )     | (11.1 ) |
| Insurance commissions, fees and premiums   | 74             | 87       | (13 )     | (14.9 ) |
| Interchange revenue from debit card transactions   | 1,431          | 1,456    | (25 )     | (1.7 )  |
| Net gains from sales of loans  | 699            | 573      | 126       | 22.0    |
| Decrease in fair value of servicing rights   | (247 )         | (137 )   | (110 )    | 80.3    |
| Increase in cash surrender value of life insurance                                       | 286            | 294      | (8 )      | (2.7 )  |
| Other operating income   | 1,243          | 1,086    | 157       | 14.5    |
| Total other operating income before realized gains on available-for-sale securities, net | \$11,480       | \$11,479 | \$ 1      | 0.0     |

Table V excludes realized gains on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table V was virtually unchanged in the first nine months of 2016 as compared to the first nine months of 2015. The most significant variances include the following:

Other operating income increased \$157,000, reflecting an increase of \$91,000 in revenue from the redemption of tax credits. Also, other income associated with lending programs increased by a total of \$59,000, including increases in fees associated with providing credit enhancement for the Mortgage Partnership Finance (MPF) Original Program, providing access to certain U.S. Government programs and from the Corporation’s participation in a title insurance entity on a co-operative basis with other banks.

Net gains on the sale of loans increased \$126,000 (22.0%). The Corporation originates and sells some of its residential mortgage production under the MPF Original and Xtra Programs, administered by the Federal Home Loan Banks of Chicago and Pittsburgh. The 2016 increase in net gains from sales reflects the effects of a higher volume of residential mortgage sales, along with a higher margin on loans sold. For the first nine months of 2016, the amount of residential mortgage loans originated for the purpose of sale totaled \$19.4 million, an increase of 16.6% over the first nine months of 2015, and total cash proceeds from residential mortgage loans sold in the first nine months of 2016 amounted to \$19.6 million, an increase of 15.3% over the amount for the first nine months of 2015.

Trust and Financial Management revenue increased \$89,000 (2.6%), reflecting an increase in the balance of Trust assets under management. Trust assets under management amounted to \$867,852,000 at September 30, 2016, an increase of 6.5% over the total at December 31, 2015 and 9.8% over the corresponding total at September 30, 2015. Increases in Trust assets under management have resulted from an overall valuation increase in the U.S. stock market, along with growth from new business.

The fair value of mortgage servicing rights decreased \$247,000 in the first nine months of 2016, primarily from changes in prepayment assumptions driven by market expectations of lower interest rates. In comparison, the fair value of mortgage servicing rights decreased \$137,000 in the first nine months of 2015.

Service charges on deposit accounts decreased \$106,000 (2.9%), mainly as a result of a reduction in consumer overdraft volume.

Brokerage revenue declined \$71,000, as the volume of sales of annuities declined.

**TABLE VI - COMPARISON OF NONINTEREST INCOME****(In Thousands)**

|  | 3 Months Ended |         |          |          |
|--|----------------|---------|----------|----------|
|  | September 30,  |         | \$       | %        |
|  | 2016           | 2015    | Change   | Change   |
| Service charges on deposit accounts  | \$1,221        | \$1,302 | \$ (81 ) | (6.2 )   |
| Service charges and fees   | 118            | 137     | (19 )    | (13.9 )  |
| Trust and financial management revenue   | 1,172          | 1,123   | 49       | 4.4      |
| Brokerage revenue  | 216            | 215     | 1        | 0.5      |
| Insurance commissions, fees and premiums   | 26             | 24      | 2        | 8.3      |
| Interchange revenue from debit card transactions   | 481            | 482     | (1 )     | (0.2 )   |
| Net gains from sales of loans  | 236            | 243     | (7 )     | (2.9 )   |
| (Decrease) increase in fair value of servicing rights                                    | (68 )          | 13      | (81 )    | (623.1 ) |
| Increase in cash surrender value of life insurance                                       | 97             | 95      | 2        | 2.1      |
| Other operating income   | 385            | 327     | 58       | 17.7     |
| Total other operating income before realized gains on available-for-sale securities, net | \$3,884        | \$3,961 | \$ (77 ) | (1.9 )   |

Table VI excludes realized gains on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table VI decreased \$77,000, or 1.9%, in the three months ended September 30, 2016 as compared to the three months ended September 30, 2015. The most significant variances include the following:

Service charges on deposit accounts decreased \$81,000, or 6.2%, primarily as a result of a lower volume of consumer overdrafts.

The fair value of mortgage servicing rights decreased \$68,000 in the third quarter 2016, primarily from changes in prepayment assumptions driven by market expectations of lower interest rates. In comparison, the fair value of mortgage servicing rights increased \$13,000 in the third quarter 2015.

Other operating income increased \$58,000 in 2016, with increases in several categories, most significantly dividends received on Federal Home Loan Bank of Pittsburgh stock.

Trust and financial management revenue increased \$49,000 (4.4%) in the third quarter 2016 as compared to the third quarter 2015, reflecting growth in the amount of Trust assets under management and including an increase in revenue from retirement plan services of \$16,000.

**TABLE VII - COMPARISON OF NONINTEREST EXPENSE****(In Thousands)**

|  | 9 Months Ended |          |        |          |
|--|----------------|----------|--------|----------|
|  | September 30,  |          | \$     | %        |
|  | 2016           | 2015     | Change | Change   |
| Salaries and wages                               | \$11,701       | \$10,834 | \$ 867 | 8.0      |
| Pensions and other employee benefits             | 3,499          | 3,336    | 163    | 4.9      |
| Occupancy expense, net                           | 1,770          | 1,985    | (215 ) | (10.8 )  |
| Furniture and equipment expense                  | 1,301          | 1,398    | (97 )  | (6.9 )   |
| FDIC Assessments                                 | 448            | 454      | (6 )   | (1.3 )   |
| Pennsylvania shares tax                          | 932            | 946      | (14 )  | (1.5 )   |
| Professional fees                                | 816            | 437      | 379    | 86.7     |
| Automated teller machine and interchange expense | 807            | 735      | 72     | 9.8      |
| Software subscriptions                           | 729            | 617      | 112    | 18.2     |
| Loss on prepayment of borrowings                 | 0              | 910      | (910 ) | (100.0 ) |
| Other operating expense                          | 4,183          | 3,872    | 311    | 8.0      |
| Total Other Expense                              | \$26,186       | \$25,524 | \$ 662 | 2.6      |

As shown in Table VII, total noninterest expense increased \$662,000 or 2.6% in the first nine months of 2016 as compared to the first nine months of 2015. Excluding the \$910,000 loss on prepayment of debt in 2015, total noninterest expense increased \$1,572,000, or 6.4%. Other significant variances include the following:

Salaries and wages expense increased \$867,000 (8.0%), reflecting an increase in number of employees. The average number of full-time equivalent employees was 287 in 2016, up from 278 in 2015, including new positions established for lending, lending support, information technology, training and marketing functions.

Professional fees expense increased \$379,000 (86.7%) in the first nine months 2016 over the first nine months of 2015 amount, including increases related to employee sales and service training, information technology, marketing and outsourced commercial loan credit review.

Other operating expense increased \$311,000 (8.0%) in the first nine months of 2016 over the first nine months of 2015, including an increase in charitable donations of \$90,000, an \$86,000 increase in education and training related expenses and a \$48,000 increase in other real estate expenses. Also, other operating expense was reduced in 2015 by \$69,000 as a result of a recovery of sales tax previously paid. Within other operating expense, net collections-related expense was \$59,000 lower in the first nine months of 2016 as compared to the corresponding period in 2015.

Pensions and other employee benefits increased \$163,000 (4.9%) in the first nine months of 2016 over the first nine months of 2015 as a result of increased healthcare claims on the Corporation's partially self-insured plan as well as increases in other benefits attributable to having more personnel.

Software subscriptions and updates increased \$112,000 (18.2%) in the first nine months of 2016 over the first nine months 2015 as a result of enhancements and new applications initiated in 2015 and continuing into 2016.

Occupancy expense in the first nine months of 2016 was \$215,000 (10.8%) lower than the total for the first nine months of 2015, primarily as a result of lower depreciation expense and lower winter-related expenses such as snow removal and fuel costs.

#### TABLE VIII - COMPARISON OF NONINTEREST EXPENSE

(In Thousands)

|                    | 3 Months Ended     |                    |           |          |
|--------------------|--------------------|--------------------|-----------|----------|
|                    | September 30, 2016 | September 30, 2015 | \$ Change | % Change |
| Salaries and wages | \$3,901            | \$3,744            | \$ 157    | 4.2      |

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|  |         |         |        |        |
|--|---------|---------|--------|--------|
| Pensions and other employee benefits             | 1,060   | 1,016   | 44     | 4.3    |
| Occupancy expense, net                           | 601     | 623     | (22 )  | (3.5 ) |
| Furniture and equipment expense                  | 435     | 477     | (42 )  | (8.8 ) |
| FDIC Assessments                                 | 151     | 155     | (4 )   | (2.6 ) |
| Pennsylvania shares tax                          | 287     | 311     | (24 )  | (7.7 ) |
| Professional fees                                | 245     | 141     | 104    | 73.8   |
| Automated teller machine and interchange expense | 291     | 234     | 57     | 24.4   |
| Software subscriptions                           | 237     | 209     | 28     | 13.4   |
| Other operating expense                          | 1,371   | 1,207   | 164    | 13.6   |
| Total Other Expense                              | \$8,579 | \$8,117 | \$ 462 | 5.7    |

As shown in Table VIII, total noninterest expense increased \$462,000, or 5.7%, in the three months ended September 30, 2016 as compared to the same period of 2015. Significant variances include the following:

Salaries and wages expense increased \$157,000 (4.2%), reflecting an increase in number of employees. The average number of full-time equivalent employees was 288 in the third quarter 2016, up from 279 in the third quarter 2015, including new positions established for lending, lending support, information technology, training, human resources and marketing functions.

Professional fees expense increased \$104,000 (73.8%) in the three months ended September 30, 2016 over the same period in 2015, including increases related to employee sales and service training, information technology, marketing and outsourced commercial loan credit review.

Other operating expense increased \$164,000 (13.6%) in the three months ended September 30, 2016 over the same period in 2015, including increases in education and training-related expense of \$29,000, net collection-related expenses of \$29,000 and expenses related to other real estate properties of \$27,000. Also, other operating expense in the third quarter 2015 was reduced by a refund of \$69,000 from recovery of previously-paid sales tax, with no corresponding recovery in the third quarter 2016.

## FINANCIAL CONDITION

Gross loans outstanding (excluding mortgage loans held for sale) were \$742,338,000 at September 30, 2016, up 5.3% from \$704,880,000 at December 31, 2015 and up 9.2% from \$679,865,000 at September 30, 2015. The total outstanding balances of residential mortgage segment loans at September 30, 2016 increased \$24,170,000 (6.3%) as compared to December 31, 2015 and \$29,345,000 (7.7%) as compared to September 30, 2015. The total outstanding balances of commercial segment loans at September 30, 2016 increased \$11,138,000 (3.6%) as compared to December 31, 2015 and \$30,482,000 (10.6%) as compared to September 30, 2015.

The increases in loans outstanding in the latter half of 2015 and first nine months of 2016 included increases in commercial participation loans. Participation loans represent portions of larger commercial transactions for which other institutions are the “lead banks”. Although not the lead bank, the Corporation conducts detailed underwriting and monitoring of participation loan opportunities. Participation loans are included in the “Commercial and industrial,” “Commercial loans secured by real estate” and “Political subdivisions” classes in the loan tables presented in this Form 10-Q. Total participation loans outstanding amounted to \$48,670,000 at September 30, 2016, up from \$44,456,000 at December 31, 2015 and \$32,332,000 at September 30, 2015. At September 30, 2016, the balance of participation loans outstanding includes a total of \$34,564,000 to businesses located outside of the Corporation’s market area, including \$11,996,000 from participations in loans originated through the Corporation’s membership in a network that originates loans throughout the U.S. The Corporation’s participation loans originated through the network consist of loans to businesses that are larger than the Corporation’s typical commercial customer base. The loans originated through the network are considered “leveraged loans,” meaning the businesses typically have minimal tangible book equity and the extent of collateral available is limited, though the businesses have demonstrated strong cash flow performance in their recent histories. At September 30, 2016, total leveraged participation loans, including loans originated through the network and a loan originated through another lead institution, totaled \$14,688,000.

Other significant changes in the average balances of the Corporation’s earning assets and interest-bearing liabilities are described in the “Net Interest Income” section of Management’s Discussion and Analysis. Other significant balance sheet items, including the allowance for loan losses and stockholders’ equity, are discussed in separate sections of Management’s Discussion and Analysis.

Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition in 2016.

Since 2009, the Corporation has originated and sold residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Residential mortgages originated and sold through the MPF Xtra program consist primarily of conforming, prime loans sold to the Federal National Mortgage Association (Fannie Mae), a government agency. In 2014, the Corporation began to originate and sell residential mortgage loans to the secondary market through the MPF Original program, which is also administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Residential mortgages originated and sold through the MPF Original program consist primarily of conforming, prime loans sold to the Federal Home Loan Bank of Pittsburgh. For loans sold under the Original program, the Corporation provides a credit enhancement whereby the Corporation would assume credit losses in excess of a defined First Loss Account ("FLA") balance, up to specified amounts. The FLA is funded by the Federal Home Loan Bank of Pittsburgh based on a percentage of the outstanding balance of loans sold. At September 30, 2016, the Corporation has recorded an allowance in the amount of \$169,000 for credit losses on loans sold under the MPF Original Program which is included in "Accrued interest and other liabilities" in the accompanying balance sheet. There was no allowance recorded at December 31, 2015. The Corporation does not provide a credit enhancement for loans sold through the Xtra program.

For loan sales originated under the MPF Xtra and Original programs, the Corporation provides customary representations and warranties to investors that specify, among other things, that the loans have been underwritten to the standards established by the investor. The Corporation may be required to repurchase a loan and reimburse a portion of fees received, or reimburse the investor for a credit loss incurred on a loan, if it is determined that the representations and warranties have not been met. Such repurchases or reimbursements generally result from an underwriting or documentation deficiency. At September 30, 2016, the total outstanding balance of loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to \$1,866,000, and the corresponding total outstanding balance repurchased at December 31, 2015 was \$1,968,000.

At September 30, 2016, outstanding balances of loans sold and serviced through the two programs totaled \$157,845,000, including loans sold through the MPF Xtra program of \$117,738,000 and loans sold through the Original program of \$40,107,000. At December 31, 2015, outstanding balances of loans sold and serviced through the two programs totaled \$152,448,000, including loans sold through the MPF Xtra program of \$125,571,000 and loans sold through the Original Program of \$26,877,000. Based on the fairly limited volume of required repurchases to date, no allowance had been established for representation and warranty exposures as of September 30, 2016 and December 31, 2015.

#### PROVISION AND ALLOWANCE FOR LOAN LOSSES

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction of the investment in loans. Note 7 to the unaudited consolidated financial statements provides an overview of the process management uses for evaluating and determining the allowance for loan losses.

While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

The allowance for loan losses was \$8,421,000 at September 30, 2016, up from \$7,889,000 at December 31, 2015. Table X shows the collectively determined component of the allowance for residential mortgages was \$382,000 higher at September 30, 2016 than at December 31, 2015, reflecting growth in outstanding loans and the use of slightly higher qualitative factors to estimate the required allowance. Also, the collectively determined component of the allowance for commercial loans was \$291,000 higher at September 30, 2016 than at December 31, 2015, reflecting the effects of growth in outstanding loans and increases in the average net charge-offs experience and qualitative factors used to estimate the required allowance.

The provision (credit) for loan losses by segment in the three-month and nine-month period ended September 30, 2016 and 2015 is as follows:

| (In Thousands)       | 3 Months Ended |                | 9 Months Ended  |                |
|----------------------|----------------|----------------|-----------------|----------------|
|                      | Sept. 30, 2016 | Sept. 30, 2015 | Sept. 30, 2016  | Sept. 30, 2015 |
| Residential mortgage | \$ 178         | \$ (17 )       | \$ 452          | \$ 52          |
| Commercial           | 337            | 282            | 750             | 443            |
| Consumer             | 23             | 6              | 51              | (1 )           |
| Unallocated          | 0              | 31             | (29 )           | 32             |
| <b>Total</b>         | <b>\$ 538</b>  | <b>\$ 302</b>  | <b>\$ 1,224</b> | <b>\$ 526</b>  |

As shown in the table above, the provision for loan losses for the third quarter 2016 exceeded the third quarter 2015 amount by \$236,000, with the largest increases in the residential mortgage and commercial segments. In the third quarter 2016, the provision related to residential mortgage loans included an increase of \$142,000 in the qualitative factors component of the collectively determined allowance. In comparison, the net credit related to the residential mortgage segment in the third quarter 2015 included an increase related to qualitative factors of \$55,000, but also included a credit of \$78,000 related to the change in total specific allowances on impaired loans, as adjusted for net charge-offs during the period. For the commercial segment, the third quarter 2016 provision included \$433,000 from the increase in total specific allowances on impaired loans, as adjusted for net charge-offs, and \$26,000 from an increase in the allowance related to qualitative factors, reduced \$122,000 by improvement in the net charge-offs experience component of the collectively determined allowance. In comparison, the main components of the commercial provision in the third quarter 2015 included an increase in the collectively determined portion of the allowance based on qualitative factors of \$141,000 and a net increase in specific allowances on impaired loans of \$108,000.

The provision for loan losses for the nine months ended September 30, 2016 totaled \$1,224,000, an increase of \$698,000 over the corresponding amount for the first nine months of 2015. In the first nine months of 2016, the provision related to the residential mortgage segment increased \$400,000, and the provision related to the commercial segment increased \$307,000. For the nine-month period ended September 30, 2016, the provision related to residential mortgage loans included an increase of \$70,000 related to the change in total specific allowances on impaired loans, as adjusted for net charge-offs during the period, while the net provision for the first nine months of 2015 included a credit of \$164,000 attributable to a net reduction in specific allowances on impaired residential mortgage loans. Also, the provision related to residential mortgage loans in the first nine months of 2016 included an increase of \$367,000 in the qualitative factors component of the allowance as compared to an increase of \$127,000 in the qualitative factors component in the first nine months of 2015. For the commercial segment, the provision for the first nine months of 2016 included \$459,000 from the increase in total specific allowances on impaired loans, as compared to a net increase of \$282,000 in specific allowances on impaired loans in the first nine months of 2015. Also, the provision related to the commercial segment for the first nine months of 2016 included \$194,000 from an increase in the qualitative factors component of the collectively determined portion of the allowance as compared to a corresponding \$80,000 increase in the first nine months of 2015.

Table XI presents information related to past due and impaired loans, and loans that have been modified under terms that are considered troubled debt restructurings (TDRs). Total nonperforming loans as a percentage of outstanding loans was 2.70% at September 30, 2016, up from 2.09% at December 31, 2015, and nonperforming assets as a percentage of total assets was 1.79% at September 30, 2016, up from 1.31% at December 31, 2015. Table XI presents data at September 30, 2016 and at the end of each of the years ended December 31, 2011 through 2015. For the range of dates presented in Table XI, total nonperforming loans as a percentage of loans has ranged from a low of 1.19% at December 31, 2011 to a high of 2.80% at December 31, 2013, and total nonperforming assets as a percentage of assets has ranged from a low of 0.73% at December 31, 2011 to a high of 1.79% at September 30, 2016.

Total impaired loans of \$11,135,000 at September 30, 2016, are up \$1,161,000 from the corresponding amount at December 31, 2015 of \$9,974,000, including an increase in impaired loans with a valuation allowance of \$1,688,000. In the third quarter 2016, the Corporation recorded an allowance of \$528,000 related to one real estate secured commercial loan relationship with total loans outstanding of \$3,347,000, including one loan with an outstanding balance of \$2,695,000 that was classified as impaired with a valuation allowance at September 30, 2016.

Total nonperforming assets of \$22,341,000 at September 30, 2016 are up \$6,335,000 from the corresponding amount at December 31, 2015, including increases in nonaccrual loans, loans past due 90 days or more and still accruing interest and foreclosed (real estate) assets held for sale, summarized as follows:

Total nonaccrual loans at September 30, 2016 of \$12,481,000 was \$964,000 higher than the corresponding December 31, 2015 total, including the effect of classifying the real estate secured commercial loan noted above with an outstanding balance at September 30, 2016 of \$2,695,000 as nonaccrual in the third quarter 2016.

Total loans past due 90 days or more and still accruing interest amounted to \$7,539,000 at September 30, 2016, an increase of \$4,310,000 from \$3,229,000 at December 31, 2015. The increase in 2016 in the balance of loans past due 90 days or more and still accruing interest included a commercial loan with a balance of \$2,697,000 at September 30, 2016 that was deemed by management to be well secured and in the process of collection. At September 30, 2016, in addition to this commercial loan, total residential mortgage loans that were more than 90 days past due but deemed to be well secured and in the process of collection amounted to \$4,016,000, up from \$2,381,000 at December 31, 2015. The Corporation reviews the status of loans past due 90 days or more each quarter to determine if it is appropriate to continue to accrue interest, and has determined the loans included in this category are well secured and that ultimate collection of all principal and interest is probable.

Foreclosed assets held for sale consisted of real estate, and totaled \$2,321,000 at September 30, 2016, an increase of \$1,061,000 from \$1,260,000 at December 31, 2015. At September 30, 2016, the Corporation held 22 such properties for sale, with total carrying values of \$1,195,000 related to residential real estate, \$696,000 of land and \$430,000 related to commercial real estate. At December 31, 2016, the Corporation held 12 such properties for sale, with total carrying values of \$556,000 related to residential real estate and \$704,000 of land. The Corporation evaluates the carrying values of foreclosed assets each quarter based on the most recent market activity or appraisals for each property.

The outstanding balances of impaired loans without a valuation allowance, nonaccrual loans and nonperforming TDRs at September 30, 2016, include an outstanding balance of \$4,836,000 from loans to one commercial entity. In 2014, the Corporation entered into a forbearance agreement with this commercial borrower which included a reduction in monthly payment amounts over a fifteen-month period. At the end of the fifteen-month period, the monthly payment amounts would revert to the original amounts, unless the forbearance agreement was extended or the payment requirements otherwise modified. The forbearance agreement has been extended for two additional twelve-month periods, most recently in July 2016. The Corporation recorded a charge-off of \$1,486,000 in the second quarter 2014 as a result of these modifications, as the payment amounts based on the forbearance agreement are not sufficient to fully amortize the contractual amount of principal outstanding on the loans. The borrower has made all required payments on the loans in accordance with the terms of the forbearance agreement, as extended.

Each period presented in Table XI includes a few large commercial relationships that have required significant monitoring and workout efforts. As a result, a limited number of relationships may significantly impact the total amount of allowance required on impaired loans, and may significantly impact the amount of total charge-offs reported in any one period.

Management believes it has been conservative in its decisions concerning identification of impaired loans, estimates of loss, and nonaccrual status; however, the actual losses realized from these relationships could vary materially from the allowances calculated as of September 30, 2016. Management continues to closely monitor its commercial loan relationships for possible credit losses, and will adjust its estimates of loss and decisions concerning nonaccrual status, if appropriate.

Tables IX through XII present historical data related to loans and the allowance for loan losses.

#### TABLE IX - ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

(In Thousands)

|                            | 9 Months Ended       |                   |                          |         |         |         |         |
|----------------------------|----------------------|-------------------|--------------------------|---------|---------|---------|---------|
|                            | Sept.<br>30,<br>2016 | Sept. 30,<br>2015 | Years Ended December 31, |         |         |         |         |
|                            |                      |                   | 2015                     | 2014    | 2013    | 2012    | 2011    |
| Balance, beginning of year | \$7,889              | \$ 7,336          | \$7,336                  | \$8,663 | \$6,857 | \$7,705 | \$9,107 |
| Charge-offs:               |                      |                   |                          |         |         |         |         |
| Residential mortgage       | (73 )                | (191 )            | (217 )                   | (327 )  | (95 )   | (552 )  | (100 )  |
| Commercial                 | (597 )               | (240 )            | (251 )                   | (1,715) | (459 )  | (498 )  | (1,189) |
| Consumer                   | (67 )                | (65 )             | (94 )                    | (97 )   | (117 )  | (171 )  | (157 )  |

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|   |         |         |         |         |         |         |         |
|---|---------|---------|---------|---------|---------|---------|---------|
| Total charge-offs                       | (737 )  | (496 )  | (562 )  | (2,139) | (671 )  | (1,221) | (1,446) |
| Recoveries:                             |         |         |         |         |         |         |         |
| Residential mortgage                    | 2       | 1       | 1       | 25      | 24      | 18      | 3       |
| Commercial                              | 4       | 5       | 214     | 264     | 348     | 8       | 255     |
| Consumer                                | 39      | 44      | 55      | 47      | 58      | 59      | 71      |
| Total recoveries                        | 45      | 50      | 270     | 336     | 430     | 85      | 329     |
| Net charge-offs                         | (692 )  | (446 )  | (292 )  | (1,803) | (241 )  | (1,136) | (1,117) |
| Provision (credit) for loan losses      | 1,224   | 526     | 845     | 476     | 2,047   | 288     | (285 )  |
| Balance, end of period                  | \$8,421 | \$7,416 | \$7,889 | \$7,336 | \$8,663 | \$6,857 | \$7,705 |
| Net charge-offs as a % of average loans | 0.10 %  | 0.07 %  | 0.04 %  | 0.29 %  | 0.04 %  | 0.16 %  | 0.16 %  |

**TABLE X - COMPONENTS OF THE ALLOWANCE FOR LOAN LOSSES**

**(In Thousands)**

|                                | Sept. 30,<br>2016 | As of December 31, |         |         |         |         |
|--------------------------------|-------------------|--------------------|---------|---------|---------|---------|
|                                | 2015              | 2014               | 2013    | 2012    | 2011    |         |
| ASC 310 - Impaired loans       | \$ 685            | \$820              | \$769   | \$2,333 | \$623   | \$1,126 |
| ASC 450 - Collective segments: |                   |                    |         |         |         |         |
| Commercial                     | 3,394             | 3,103              | 2,732   | 2,583   | 2,594   | 2,811   |
| Residential mortgage           | 3,799             | 3,417              | 3,295   | 3,156   | 3,011   | 3,130   |
| Consumer                       | 145               | 122                | 145     | 193     | 188     | 204     |
| Unallocated                    | 398               | 427                | 395     | 398     | 441     | 434     |
| Total Allowance                | \$ 8,421          | \$7,889            | \$7,336 | \$8,663 | \$6,857 | \$7,705 |

The above allocation is based on estimates and subjective judgments and is not necessarily indicative of the specific amounts or loan categories in which losses may occur.

**TABLE XI - PAST DUE AND IMPAIRED LOANS, NONPERFORMING ASSETS****AND TROUBLED DEBT RESTRUCTURINGS (TDRs)****(In Thousands)**

|   | As of<br>Sept. 30,<br>2016 | As of December 31,<br>2015 | 2014      | 2013      | 2012      | 2011     |
|---|----------------------------|----------------------------|-----------|-----------|-----------|----------|
| Impaired loans with a valuation allowance               | \$ 3,621                   | \$ 1,933                   | \$ 3,241  | \$ 9,889  | \$ 2,710  | \$ 3,433 |
| Impaired loans without a valuation allowance            | 7,514                      | 8,041                      | 9,075     | 6,432     | 4,719     | 4,431    |
| Total impaired loans                                    | \$ 11,135                  | \$ 9,974                   | \$ 12,316 | \$ 16,321 | \$ 7,429  | \$ 7,864 |
| Total loans past due 30-89 days and still accruing      | \$ 4,040                   | \$ 7,057                   | \$ 7,121  | \$ 8,305  | \$ 7,756  | \$ 7,898 |
| Nonperforming assets:                                   |                            |                            |           |           |           |          |
| Total nonaccrual loans                                  | \$ 12,481                  | \$ 11,517                  | \$ 12,610 | \$ 14,934 | \$ 7,353  | \$ 7,197 |
| Total loans past due 90 days or more and still accruing | 7,539                      | 3,229                      | 2,843     | 3,131     | 2,311     | 1,267    |
| Total nonperforming loans                               | 20,020                     | 14,746                     | 15,453    | 18,065    | 9,664     | 8,464    |
| Foreclosed assets held for sale (real estate)           | 2,321                      | 1,260                      | 1,189     | 892       | 879       | 1,235    |
| Total nonperforming assets                              | \$ 22,341                  | \$ 16,006                  | \$ 16,642 | \$ 18,957 | \$ 10,543 | \$ 9,699 |
| Loans subject to troubled debt restructurings (TDRs):   |                            |                            |           |           |           |          |
| Performing  | \$ 946                     | \$ 1,186                   | \$ 1,807  | \$ 3,267  | \$ 906    | \$ 1,064 |
| Nonperforming   | 5,032                      | 5,178                      | 5,388     | 908       | 1,155     | 2,413    |
| Total TDRs  | \$ 5,978                   | \$ 6,364                   | \$ 7,195  | \$ 4,175  | \$ 2,061  | \$ 3,477 |
| Total nonperforming loans as a % of loans               | 2.70 %                     | 2.09 %                     | 2.45 %    | 2.80 %    | 1.41 %    | 1.19 %   |
| Total nonperforming assets as a % of assets             | 1.79 %                     | 1.31 %                     | 1.34 %    | 1.53 %    | 0.82 %    | 0.73 %   |
| Allowance for loan losses as a % of total loans         | 1.13 %                     | 1.12 %                     | 1.16 %    | 1.34 %    | 1.00 %    | 1.09 %   |
| Allowance for loan losses as a % of nonperforming loans | 42.06 %                    | 53.50 %                    | 47.47 %   | 47.95 %   | 70.95 %   | 91.03 %  |

**TABLE XII - SUMMARY OF LOANS BY TYPE****Summary of Loans by Type****(In Thousands)**

|                       | Sept. 30,<br>2016 | As of December 31,<br>2015 | 2014 | 2013 | 2012 | 2011 |
|-----------------------|-------------------|----------------------------|------|------|------|------|
| Residential mortgage: |                   |                            |      |      |      |      |

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|   |           |           |           |           |           |           |
|---|-----------|-----------|-----------|-----------|-----------|-----------|
| Residential mortgage loans - first liens  | \$325,533 | \$304,783 | \$291,882 | \$299,831 | \$311,627 | \$331,015 |
| Residential mortgage loans - junior liens | 22,794    | 21,146    | 21,166    | 23,040    | 26,748    | 28,851    |
| Home equity lines of credit               | 38,623    | 39,040    | 36,629    | 34,530    | 33,017    | 30,037    |
| 1-4 Family residential construction       | 23,310    | 21,121    | 16,739    | 13,909    | 12,842    | 9,959     |
| Total residential mortgage                | 410,260   | 386,090   | 366,416   | 371,310   | 384,234   | 399,862   |
| Commercial:                               |           |           |           |           |           |           |
| Commercial loans secured by real estate   | 149,938   | 154,779   | 145,878   | 147,215   | 158,413   | 156,388   |
| Commercial and industrial                 | 86,969    | 75,196    | 50,157    | 42,387    | 48,442    | 57,191    |
| Political subdivisions                    | 38,653    | 40,007    | 17,534    | 16,291    | 31,789    | 37,620    |
| Commercial construction and land          | 12,809    | 5,122     | 6,938     | 17,003    | 28,200    | 23,518    |
| Loans secured by farmland                 | 6,900     | 7,019     | 7,916     | 10,468    | 11,403    | 10,949    |
| Multi-family (5 or more) residential      | 8,133     | 9,188     | 8,917     | 10,985    | 6,745     | 6,583     |
| Agricultural loans                        | 4,313     | 4,671     | 3,221     | 3,251     | 3,053     | 2,987     |
| Other commercial loans                    | 11,557    | 12,152    | 13,334    | 14,631    | 362       | 552       |
| Total commercial                          | 319,272   | 308,134   | 253,895   | 262,231   | 288,407   | 295,788   |
| Consumer                                  | 12,806    | 10,656    | 10,234    | 10,762    | 11,269    | 12,665    |
| Total                                     | 742,338   | 704,880   | 630,545   | 644,303   | 683,910   | 708,315   |
| Less: allowance for loan losses           | (8,421 )  | (7,889 )  | (7,336 )  | (8,663 )  | (6,857 )  | (7,705 )  |
| Loans, net                                | \$733,917 | \$696,991 | \$623,209 | \$635,640 | \$677,053 | \$700,610 |

**LIQUIDITY**

Liquidity is the ability to quickly raise cash at a reasonable cost. An adequate liquidity position permits the Corporation to pay creditors, compensate for unforeseen deposit fluctuations and fund unexpected loan demand. At September 30, 2016, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$9,620,000.

The Corporation maintains overnight borrowing facilities with several correspondent banks that provide a source of day-to-day liquidity. Also, the Corporation maintains borrowing facilities with the Federal Home Loan Bank of Pittsburgh, secured by various mortgage loans.

The Corporation has a line of credit with the Federal Reserve Bank of Philadelphia's Discount Window. Management intends to use this line of credit as a contingency funding source. As collateral for the line, the Corporation has pledged available-for-sale securities with a carrying value of \$18,899,000 at September 30, 2016.

The Corporation's outstanding, available, and total credit facilities at September 30, 2016 and December 31, 2015 are as follows:

| (In Thousands)                       | Outstanding    |               | Available      |               | Total Credit   |               |
|--------------------------------------|----------------|---------------|----------------|---------------|----------------|---------------|
|                                      | Sept. 30, 2016 | Dec. 31, 2015 | Sept. 30, 2016 | Dec. 31, 2015 | Sept. 30, 2016 | Dec. 31, 2015 |
| Federal Home Loan Bank of Pittsburgh | \$19,808       | \$60,348      | \$315,685      | \$262,361     | \$335,493      | \$322,709     |
| Federal Reserve Bank Discount Window | 0              | 0             | 16,802         | 19,606        | 16,802         | 19,606        |
| Other correspondent banks            | 0              | 0             | 45,000         | 45,000        | 45,000         | 45,000        |
| Total credit facilities              | \$19,808       | \$60,348      | \$377,487      | \$326,967     | \$397,295      | \$387,315     |

At September 30, 2016, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of overnight borrowings of \$2,000,000, short-term borrowings of \$6,270,000, and long-term borrowings with a total amount of \$11,538,000. At December 31, 2015, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of overnight borrowings of \$23,500,000, short-term borrowings of \$25,081,000, and long-term borrowings with a total amount of \$11,767,000. Additional information regarding borrowed funds is included in Note 8 of the unaudited consolidated financial statements.

Additionally, the Corporation uses repurchase agreements placed with brokers to borrow funds secured by investment assets and “RepoSweep” arrangements to borrow funds from commercial banking customers on an overnight basis. If required to raise cash in an emergency situation, the Corporation could sell available-for-sale securities to meet its obligations. At September 30, 2016, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was \$193,452,000.

Management believes the Corporation is well-positioned to meet its short-term and long-term obligations.

**STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY**

The Corporation and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning capital ratios at September 30, 2016 and December 31, 2015 are presented below. Management believes, as of September 30, 2016 and December 31, 2015, that the Corporation and C&N Bank meet all capital adequacy requirements to which they are subject and maintain capital conservation buffers (described in more detail in the "New Capital Rule" section below) that allow the Corporation and C&N Bank to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. Further, as reflected in the table below, the Corporation's and C&N Bank's capital ratios at September 30, 2016 and December 31, 2015 exceed the Corporation's policy threshold levels.

| (Dollars in Thousands)                                |           | Actual |          | Minimum             |          | Minimum To   |          | Minimum To   |          | Minimum To                               |       |  |
|---|-----------|--------|----------|---------------------|----------|--|----------|--|----------|--|-------|--|
|   |           |        |          | Capital Requirement |          | Maintain Capital Conservation Buffer at Reporting Date |          | Be Well Capitalized Under Prompt Corrective Provisions |          | Meet the Corporation's Policy Thresholds |       |  |
| Amount  | Ratio     | Amount | Ratio    | Amount              | Ratio    | Amount   | Ratio    | Amount   | Ratio    | Amount                                   | Ratio |  |
| September 30, 2016:                                   |           |        |          |                     |          |  |          |  |          |  |       |  |
| Total capital to risk-weighted assets:                |           |        |          |                     |          |  |          |  |          |  |       |  |
| Consolidated  | \$181,961 | 23.56% | \$61,784 | 38 %                | \$66,611 | 38.625%  | \$77,230 | 310 %  | \$81,091 | 310.5 %                                  |       |  |
| C&N Bank  | 161,486   | 21.04% | 61,411   | 38 %                | 66,209   | 38.625%  | 76,764   | 310 %  | 80,602   | 310.5 %                                  |       |  |
| Tier 1 capital to risk-weighted assets:               |           |        |          |                     |          |  |          |  |          |  |       |  |
| Consolidated  | 173,223   | 22.43% | 30,892   | 36 %                | 51,165   | 36.625%  | 61,784   | 38 %   | 65,645   | 38.5 %                                   |       |  |
| C&N Bank  | 152,896   | 19.92% | 30,706   | 36 %                | 50,856   | 36.625%  | 61,411   | 38 %   | 65,249   | 38.5 %                                   |       |  |
| Common equity tier 1 capital to risk-weighted assets: |           |        |          |                     |          |  |          |  |          |  |       |  |
| Consolidated  | 173,223   | 22.43% | 30,892   | 34.5 %              | 39,580   | 35.125%  | 50,199   | 36.5 %   | 54,061   | 37 %                                     |       |  |
| C&N Bank  | 152,896   | 19.92% | 30,706   | 34.5 %              | 39,341   | 35.125%  | 49,897   | 36.5 %   | 53,735   | 37 %                                     |       |  |
| Tier 1 capital to average assets:                     |           |        |          |                     |          |  |          |  |          |  |       |  |
| Consolidated  | 173,223   | 14.17% | 48,885   | 34 %                | N/A      | N/A  | 61,107   | 35 %   | 61,107   | 35 %                                     |       |  |
| C&N Bank  | 152,896   | 12.66% | 48,321   | 34 %                | N/A      | N/A  | 60,401   | 35 %   | 60,401   | 35 %                                     |       |  |
| December 31, 2015:                                    |           |        |          |                     |          |  |          |  |          |  |       |  |
| Total capital to risk-weighted assets:                |           |        |          |                     |          |  |          |  |          |  |       |  |
| Consolidated  | \$181,216 | 24.40% | \$59,424 | 38 %                | N/A      | N/A  | \$74,281 | 310 %  | \$77,995 | 310.5 %                                  |       |  |

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|   |         |         |        |                   |     |     |        |                   |        |                    |
|---|---------|---------|--------|-------------------|-----|-----|--------|-------------------|--------|--------------------|
| C&N Bank  | 161,187 | 21.83 % | 59,058 | <sup>38</sup> %   | N/A | N/A | 73,823 | <sup>310</sup> %  | 77,514 | <sup>310.5</sup> % |
| Tier 1 capital to risk-weighted assets:               |         |         |        |                   |     |     |        |                   |        |                    |
| Consolidated  | 173,009 | 23.29 % | 29,712 | <sup>36</sup> %   | N/A | N/A | 59,424 | <sup>38</sup> %   | 63,139 | <sup>38.5</sup> %  |
| C&N Bank  | 153,298 | 20.77 % | 29,529 | <sup>36</sup> %   | N/A | N/A | 59,058 | <sup>38</sup> %   | 62,749 | <sup>38.5</sup> %  |
| Common equity tier 1 capital to risk-weighted assets: |         |         |        |                   |     |     |        |                   |        |                    |
| Consolidated  | 173,009 | 23.29 % | 29,712 | <sup>34.5</sup> % | N/A | N/A | 48,282 | <sup>36.5</sup> % | 51,996 | <sup>37</sup> %    |
| C&N Bank  | 153,298 | 20.77 % | 29,529 | <sup>34.5</sup> % | N/A | N/A | 47,985 | <sup>36.5</sup> % | 51,676 | <sup>37</sup> %    |
| Tier 1 capital to average assets:                     |         |         |        |                   |     |     |        |                   |        |                    |
| Consolidated  | 173,009 | 14.31 % | 48,355 | <sup>34</sup> %   | N/A | N/A | 60,444 | <sup>35</sup> %   | 60,444 | <sup>35</sup> %    |
| C&N Bank  | 153,298 | 12.81 % | 47,861 | <sup>34</sup> %   | N/A | N/A | 59,826 | <sup>35</sup> %   | 59,826 | <sup>35</sup> %    |

Management expects the Corporation and C&N Bank to maintain capital levels that exceed the regulatory standards for well-capitalized institutions and the applicable capital conservation buffers for the next 12 months and for the foreseeable future.

Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. As described in more detail in the section below titled "New Capital Rule," the Corporation and C&N Bank are subject to restrictions on the amount of dividends that may be paid without approval of banking regulatory authorities.

## NEW CAPITAL RULE

In July 2013, the federal regulatory authorities issued a new capital rule based, in part, on revisions developed by the Basel Committee on Banking Supervision to the Basel capital framework (Basel III). The Corporation and C&N Bank became subject to the new rule effective January 1, 2015. Generally, the new rule implemented higher minimum capital requirements, revised the definition of regulatory capital components and related calculations, added a new common equity tier 1 capital ratio, implemented a new capital conservation buffer, increased the risk weighting for past due loans and provided a transition period for several aspects of the new rule.

The current (new) capital rule provides that, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity tier 1 capital above its minimum risk-based capital requirements. The buffer is measured relative to risk-weighted assets. Phase-in of the capital conservation buffer requirements began January 1, 2016. The transition schedule for new ratios, including the capital conservation buffer, is as follows:

|   | As of January 1: |         |        |         |        |
|---|------------------|---------|--------|---------|--------|
|   | 2015             | 2016    | 2017   | 2018    | 2019   |
| Minimum common equity tier 1 capital ratio                                  | 4.5 %            | 4.5 %   | 4.5 %  | 4.5 %   | 4.5 %  |
| Common equity tier 1 capital conservation buffer                            | N/A              | 0.625 % | 1.25 % | 1.875 % | 2.5 %  |
| Minimum common equity tier 1 capital ratio plus capital conservation buffer | 4.5 %            | 5.125 % | 5.75 % | 6.375 % | 7.0 %  |
| Phase-in of most deductions from common equity tier 1 capital               | 40 %             | 60 %    | 80 %   | 100 %   | 100 %  |
| Minimum tier 1 capital ratio  | 6.0 %            | 6.0 %   | 6.0 %  | 6.0 %   | 6.0 %  |
| Minimum tier 1 capital ratio plus capital conservation buffer               | N/A              | 6.625 % | 7.25 % | 7.875 % | 8.5 %  |
| Minimum total capital ratio   | 8.0 %            | 8.0 %   | 8.0 %  | 8.0 %   | 8.0 %  |
| Minimum total capital ratio plus capital conservation buffer                | N/A              | 8.625 % | 9.25 % | 9.875 % | 10.5 % |

As fully phased in, a banking organization with a buffer greater than 2.5% would not be subject to additional limits on dividend payments or discretionary bonus payments; however, a banking organization with a buffer less than 2.5% would be subject to increasingly stringent limitations as the buffer approaches zero. The new rule also prohibits a banking organization from making dividend payments or discretionary bonus payments if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% as of the beginning of that quarter. Eligible net income is defined as net income for the four calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income. A summary of payout restrictions based on the capital conservation buffer is as follows:

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| Capital Conservation Buffer<br>(as a % of risk-weighted assets) | Maximum Payout<br>(as a % of eligible retained income) |   |
|---|--|---|
| Greater than 2.5%   | No payout limitation applies                           |   |
| ≤2.5% and >1.875%   | 60   | % |
| ≤1.875% and >1.25%  | 40   | % |
| ≤1.25% and >0.625%  | 20   | % |
| ≤0.625%   | 0  | % |

At September 30, 2016, the Corporation's Capital Conservation Buffer, determined based on the minimum total capital ratio, was 15.56%. C&N Bank's Capital Conservation Buffer (also determined based on the minimum total capital ratio) was 13.04%.

The Corporation's total stockholders' equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in Accumulated Other Comprehensive Income within stockholders' equity. The balance in Accumulated Other Comprehensive Income related to unrealized gains on available-for-sale securities, net of deferred income tax, amounted to \$5,388,000 at September 30, 2016 and \$2,493,000 at December 31, 2015. Changes in accumulated other comprehensive income are excluded from earnings and directly increase or decrease stockholders' equity. If available-for-sale securities

are deemed to be other-than-temporarily impaired, unrealized losses are recorded as a charge against earnings, and amortized cost for the affected securities is reduced. Note 6 to the unaudited consolidated financial statements provides additional information concerning management's evaluation of available-for-sale securities for other-than-temporary impairment at September 30, 2016.

Stockholders' equity is also affected by the underfunded or overfunded status of defined benefit pension and postretirement plans. The balance in Accumulated Other Comprehensive Income related to defined benefit plans, net of deferred income tax, was \$42,000 at September 30, 2016 and \$35,000 at December 31, 2015.

## **COMPREHENSIVE INCOME**

Comprehensive Income is the total of (1) net income, and (2) all other changes in equity from non-stockholder sources, which are referred to as Other Comprehensive Income. Changes in the components of Accumulated Other Comprehensive Income (Loss) are included in Other Comprehensive Income, and for the Corporation, consist of changes in unrealized gains or losses on available-for-sale securities and changes in underfunded or overfunded defined benefit plans. Fluctuations in interest rates significantly affect fair values of available-for-sale securities, and accordingly have an effect on Other Comprehensive Income (Loss) in each period.

Comprehensive Income totaled \$2,623,000 for the three months ended September 30, 2016 as compared to \$6,270,000 in the third quarter 2015. For the three months ended September 30, 2016, Comprehensive Income included: (1) Net Income of \$4,087,000, which was \$147,000 lower than in the third quarter 2015; (2) Other Comprehensive Loss from a decrease in net unrealized gains on available-for-sale securities of (\$1,461,000) as compared to Other Comprehensive Income of \$2,039,000 from an increase in net unrealized gains on available-for-sale securities in the third quarter 2015; and (3) Other Comprehensive Loss from defined benefit plans of (\$3,000) for the third quarters of 2016 and 2015.

Comprehensive Income totaled \$14,433,000 for the nine months ended September 30, 2016 as compared to \$13,168,000 for the nine months ended September 30, 2015. In the nine months ended September 30, 2016, Comprehensive Income included: (1) Net Income of \$11,531,000, which was \$875,000 lower than in the first nine

months of 2015; (2) Other Comprehensive Income from an increase in net unrealized gains on available-for-sale securities of \$2,895,000 as compared to Other Comprehensive Income of \$835,000 in the first nine months of 2015; and (3) Other Comprehensive Income from defined benefit plans of \$7,000 as compared to Other Comprehensive Loss of (\$73,000) in the first nine months of 2015.

## INCOME TAXES

The provision for income tax for interim periods is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The third quarter 2016 provision for income tax of \$1,451,000, or 26.20% of pre-tax income, was \$56,000 higher than the third quarter 2015 tax provision of \$1,395,000, or 24.78% of pre-tax income. The higher effective tax in the third quarter 2016 included the effects of a reduction in tax-exempt interest income of \$127,000. The reduction in tax-exempt interest income resulted from pay-offs received on municipal bonds purchased several years ago when market interest yields were higher. Also, the provision for state income tax was \$39,000 higher, primarily as a result of a catch-up adjustment to increase New York State taxes for the effect of changes in the tax methodology that first became effective in 2015.

The provision for income tax totaled \$3,847,000 for the nine months ended September 30, 2016, down \$229,000 from the amount for the first nine months of 2015. The lower tax provision in 2016 resulted from lower pre-tax income; however, the provision increased as a percentage of pre-tax income to 25.02% in 2016 from 24.73% in 2015. The higher effective tax rate included the impact of a \$253,000 reduction in tax-exempt interest income and an increase in the provision for state income tax of \$30,000 that resulted mainly from a catch-up adjustment to increase the state tax provision for New York State.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At September 30, 2016, the net deferred tax asset was \$1,544,000, down from \$3,115,000 at December 31, 2015. The most significant change in temporary difference components was an increase of \$1,560,000 in the deferred tax liability associated with unrealized gains on available-for-sale securities.

The Corporation regularly reviews deferred tax assets for recoverability based on history of earnings, expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. Management believes the recorded net deferred tax asset at September 30, 2016 is fully realizable; however, if management determines the Corporation will be unable to realize all or part of the net deferred tax asset, the Corporation would adjust the deferred tax asset, which would negatively impact earnings.

Additional information related to income taxes is presented in Note 11 to the unaudited, consolidated financial statements.

## **INFLATION**

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in short-term interest rates. Beginning in September 2007, in response to concerns about weakness in the U.S. economy, the Federal Reserve lowered the fed funds target rate numerous times; in December 2008, it established a target range of 0% to 0.25%, which it maintained through mid-December 2015. On December 16, 2015, the Federal Reserve raised their target for the federal funds rate to 0.25% to 0.50%. This decision was based on data available that suggested economic activity had been expanding at a moderate pace. This included an increase in household spending, business fixed investments increasing, and an improvement in labor market conditions. Also, throughout this period, the Federal Reserve has injected massive amounts of liquidity into the nation's monetary system through a variety of programs. The Federal Reserve has purchased large amounts of securities in an effort to keep interest rates low and stimulate economic growth. Beginning in late 2013, the Federal Reserve began reducing the amount of securities purchased under its asset purchase program and then ended the program in October 2014, though still reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and continued to roll over maturing Treasury securities at auction. The Federal Reserve maintained their commitment to this policy in their September 21, 2016 statement and anticipates doing so until normalization of the level of the federal funds rate is well under way.

Despite the current low short-term rate environment, inflation statistics indicate that the overall rate of inflation is unlikely to significantly affect the Corporation's operations within the near future. Although management cannot predict future changes in the rates of inflation, management monitors the impact of economic trends, including any indicators of inflationary pressures, in managing interest rate and other financial risks.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### **MARKET RISK**

Market risk is the risk of loss arising from adverse changes in market rates and prices of the Corporation's financial instruments. In addition to the effects of interest rates, the market prices of the Corporation's debt securities within the available-for-sale securities portfolio are affected by fluctuations in the risk premiums (amounts of spread over risk-free rates) demanded by investors. Management attempts to limit the risk that economic conditions would force the Corporation to sell securities for realized losses by maintaining a strong capital position (discussed in the "Stockholders' Equity and Capital Adequacy" section of Management's Discussion and Analysis) and ample sources of liquidity (discussed in the "Liquidity" section of Management's Discussion and Analysis).

The Corporation's two major categories of market risk are interest rate risk and equity securities risk, which are discussed in the following sections.

#### **INTEREST RATE RISK**

Business risk arising from changes in interest rates is an inherent factor in operating a bank. The Corporation's assets are predominantly long-term, fixed-rate loans and debt securities. Funding for these assets comes principally from shorter-term deposits and borrowed funds. Accordingly, there is an inherent risk of lower future earnings or decline in fair value of the Corporation's financial instruments when interest rates change.

The Corporation uses a simulation model to calculate the potential effects of interest rate fluctuations on net interest income and the market value of portfolio equity. For purposes of these calculations, the market value of portfolio equity includes the fair values of financial instruments, such as securities, loans, deposits and borrowed funds, and the book values of nonfinancial assets and liabilities, such as premises and equipment and accrued expenses. The model measures and projects the amount of potential changes in net interest income, and calculates the discounted present value of anticipated cash flows of financial instruments, assuming an immediate increase or decrease in interest rates. Management ordinarily runs a variety of scenarios within a range of plus or minus 100-400 basis points of current rates.

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage-backed securities and call activity on other investment securities. Actual results could vary

significantly from these estimates, which could result in significant differences in the calculations of projected changes in net interest income and market value of portfolio equity. Also, the model does not make estimates related to changes in the composition of the deposit portfolio that could occur due to rate competition, and the table does not necessarily reflect changes that management would make to realign the portfolio as a result of changes in interest rates.

The Corporation's Board of Directors has established policy guidelines for acceptable levels of interest rate risk, based on an immediate increase or decrease in interest rates. The policy limits acceptable fluctuations in net interest income from the baseline (flat rates) one-year scenario and variances in the market value of portfolio equity from the baseline values based on current rates.

Table XIII, which follows this discussion, is based on the results of calculations performed using the simulation model as of July 31, 2016 and December 31, 2015. The table shows that as of the respective dates, the changes in net interest income and changes in market value were within the policy limits in all scenarios.

**TABLE XIII - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES**

July 31, 2016 Data

| Basis Point<br>Change in Rates | Period Ending July 31, 2017 |                     |                              |                 |                   |      |   |
|--------------------------------|-----------------------------|---------------------|------------------------------|-----------------|-------------------|------|---|
|                                | Interest<br>Income          | Interest<br>Expense | Net Interest<br>Income (NII) | NII<br>% Change | NII<br>Risk Limit |      |   |
| <b>+400</b>                    | \$52,459                    | \$22,058            | \$ 30,401                    | -19.3           | %                 | 25.0 | % |
| <b>+300</b>                    | 49,766                      | 17,276              | 32,490                       | -13.7           | %                 | 20.0 | % |
| <b>+200</b>                    | 47,042                      | 12,576              | 34,466                       | -8.5            | %                 | 15.0 | % |
| <b>+100</b>                    | 44,249                      | 8,131               | 36,118                       | -4.1            | %                 | 10.0 | % |
| 0                              | 41,379                      | 3,717               | 37,662                       | 0.0             | %                 | 0.0  | % |
| -100                           | 38,822                      | 3,228               | 35,594                       | -5.5            | %                 | 10.0 | % |
| -200                           | 37,849                      | 3,194               | 34,655                       | -8.0            | %                 | 15.0 | % |
| -300                           | 37,408                      | 3,194               | 34,214                       | -9.2            | %                 | 20.0 | % |
| -400                           | 37,272                      | 3,194               | 34,078                       | -9.5            | %                 | 25.0 | % |

Market Value of Portfolio Equity at July 31, 2016

| Basis Point<br>Change in Rates | Present<br>Value |          | Present<br>Value |            | Present<br>Value |            |
|--------------------------------|------------------|----------|------------------|------------|------------------|------------|
|                                | Equity           | % Change | % Change         | Risk Limit | Risk Limit       | Risk Limit |
| <b>+400</b>                    | \$ 171,023       | -23.2    | %                | 50.0       | %                | %          |
| <b>+300</b>                    | 182,116          | -18.2    | %                | 45.0       | %                | %          |
| <b>+200</b>                    | 195,320          | -12.3    | %                | 35.0       | %                | %          |
| <b>+100</b>                    | 208,307          | -6.4     | %                | 25.0       | %                | %          |
| 0                              | 222,627          | 0.0      | %                | 0.0        | %                | %          |
| -100                           | 220,366          | -1.0     | %                | 25.0       | %                | %          |
| -200                           | 236,569          | 6.3      | %                | 35.0       | %                | %          |
| -300                           | 273,916          | 23.0     | %                | 45.0       | %                | %          |
| -400                           | 305,754          | 37.3     | %                | 50.0       | %                | %          |

December 31, 2015 Data

| Basis Point<br>Change in Rates | Period Ending December 31, 2016 |                     |                              |                 |                   |      |   |
|--------------------------------|---------------------------------|---------------------|------------------------------|-----------------|-------------------|------|---|
|                                | Interest<br>Income              | Interest<br>Expense | Net Interest<br>Income (NII) | NII<br>% Change | NII<br>Risk Limit |      |   |
| <b>+400</b>                    | \$ 52,181                       | \$ 21,985           | \$ 30,196                    | -20.8           | %                 | 25.0 | % |
| <b>+300</b>                    | 49,687                          | 17,282              | 32,405                       | -15.0           | %                 | 20.0 | % |
| <b>+200</b>                    | 47,136                          | 12,659              | 34,477                       | -9.6            | %                 | 15.0 | % |
| <b>+100</b>                    | 44,546                          | 8,109               | 36,437                       | -4.4            | %                 | 10.0 | % |
| 0                              | 41,835                          | 3,715               | 38,120                       | 0.0             | %                 | 0.0  | % |
| -100                           | 39,116                          | 3,171               | 35,945                       | -5.7            | %                 | 10.0 | % |

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|      |        |       |        |       |   |      |   |
|------|--------|-------|--------|-------|---|------|---|
| -200 | 37,417 | 3,168 | 34,249 | -10.2 | % | 15.0 | % |
| -300 | 36,838 | 3,168 | 33,670 | -11.7 | % | 20.0 | % |
| -400 | 36,689 | 3,168 | 33,521 | -12.1 | % | 25.0 | % |

Market Value of Portfolio Equity at December 31, 2015

| Basis Point     | Present Value | Present Value | Present Value |   |   |
|-----------------|---------------|---------------|---------------|---|---|
| Change in Rates | Equity        | % Change      | Risk Limit    |   |   |
| <b>+400</b>     | \$ 167,741    | -24.4         | 50.0          | % | % |
| <b>+300</b>     | 179,772       | -18.9         | 45.0          | % | % |
| <b>+200</b>     | 193,823       | -12.6         | 35.0          | % | % |
| <b>+100</b>     | 207,803       | -6.3          | 25.0          | % | % |
| 0               | 221,750       | 0.0           | 0.0           | % | % |
| -100            | 223,517       | 0.8           | 25.0          | % | % |
| -200            | 225,185       | 1.5           | 35.0          | % | % |
| -300            | 250,353       | 12.9          | 45.0          | % | % |
| -400            | 286,210       | 29.1          | 50.0          | % | % |

**EQUITY SECURITIES RISK**

The Corporation's equity securities portfolio consists of investments in stocks of banks and bank holding companies. Investments in bank stocks are subject to risk factors that affect the banking industry in general, including credit risk, competition from non-bank entities, interest rate risk and other factors, which could result in a decline in market prices. Also, losses could occur in individual stocks held by the Corporation because of specific circumstances related to each bank.

Equity securities held as of September 30, 2016 and December 31, 2015 are presented in Table XIV. Table XIV presents quantitative data concerning the effects of a decline in fair value of the Corporation's equity securities of 10% or 20%. The data in Table XIV does not reflect the effects of any appreciation in value that may occur, nor does it present the Corporation's maximum exposure to loss on equity securities, which would be 100% of their fair value as of September 30, 2016.

**TABLE XIV - EQUITY SECURITIES RISK****(In Thousands)**

|  | Sept. 30,<br>2016 | Dec. 31,<br>2015 |
|--|-------------------|------------------|
| Cost                                     | \$ 752            | \$ 1,680         |
| Fair Value                               | 1,080             | 2,386            |
| Hypothetical 10% Decline In Market Value | (108 )            | (239 )           |
| Hypothetical 20% Decline In Market Value | (216 )            | (477 )           |

**ITEM 4. CONTROLS AND PROCEDURES**

The Corporation's management, under the supervision of and with the participation of the Corporation's Chief Executive Officer and Chief Financial Officer, has carried out an evaluation of the design and effectiveness of the Corporation's disclosure controls and procedures as defined in Rule 13a-15(e) and Rule 15d-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Corporation's disclosure controls and procedures are effective to ensure that all material information required to be disclosed in reports the Corporation files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

There were no significant changes in the Corporation's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or that are reasonably likely to affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings

The Corporation and C&N Bank are involved in various legal proceedings incidental to their business. Management believes the aggregate liability, if any, resulting from such pending and threatened legal proceedings will not have a material, adverse effect on the Corporation's financial condition or results of operations.

## Item 1A. Risk Factors

There have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation's Form 10-K filed February 18, 2016.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

The following table sets forth a summary of the purchases by the Corporation, on the open market, of its equity securities during the third quarter 2016:

| Period                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|------------------------|----------------------------------|------------------------------|--|--|
| July 1 - 31, 2016      | 0                                | \$ 0                         | 0  | 600,000  |
| August 1 - 31, 2016    | 0                                | \$ 0                         | 0  | 600,000  |
| September 1 - 30, 2016 | 0                                | \$ 0                         | 0  | 600,000  |

Note to Table: Effective April 21, 2016, the Corporation's Board of Directors approved a new treasury stock repurchase program. Under the newly approved stock repurchase program, the Corporation is authorized to repurchase up to 600,000 shares of the Corporation's common stock or slightly less than 5% of the Corporation's issued and outstanding shares at April 19, 2016. The Board of Directors' April 21, 2016 authorization provides that: (1) the new

treasury stock repurchase program shall be effective when publicly announced and shall continue thereafter until suspended or terminated by the Board of Directors, in its sole discretion; and (2) all shares of common stock repurchased pursuant to the new program shall be held as treasury shares and be available for use and reissuance for purposes as and when determined by the Board of Directors including, without limitation, pursuant to the Corporation's Dividend Reinvestment and Stock Purchase Plan and its equity compensation program. To date, no purchases have been made under this repurchase program.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

**Item 6. Exhibits**

|  |   |
|--|---|
| 2. Plan of acquisition, reorganization, arrangement, liquidation or succession | Not applicable  |
| 3. (i) Articles of Incorporation   | Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed September 21, 2009   |
| 3. (ii) By-laws  | Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed April 19, 2013   |
| 4. Instruments defining the rights of Security holders, including indentures   | Not applicable  |
| 10. Material contracts   | Not applicable  |
| 11. Statement re: computation of per share earnings                            | Information concerning the computation of earnings per share is provided in Note 2 to the unaudited consolidated financial statements, which is included in Part I, Item 1 of Form 10-Q |
| 15. Letter re: unaudited interim information                                   | Not applicable  |
| 18. Letter re: change in accounting principles                                 | Not applicable  |
| 19. Report furnished to security holders                                       | Not applicable  |
| 22. Published report regarding matters submitted to vote of security holders   | Not applicable  |
| 23. Consents of experts and counsel  | Not applicable  |
| 24. Power of attorney  | Not applicable  |
| 31. Rule 13a-14(a)/15d-14(a) certifications:                                   |   |
| 31.1 Certification of Chief Executive Officer                                  | Filed herewith  |
| 31.2 Certification of Chief Financial Officer                                  | Filed herewith  |
| 32. Section 1350 certifications  | Filed herewith  |
| 99. Additional exhibits  | Not applicable  |

100. XBRL-related documents                      Not applicable

101. Interactive data file                         Filed herewith

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CITIZENS & NORTHERN  
CORPORATION

November 3, 2016 By: /s/ J. Bradley Scovill  
Date President and Chief Executive Officer

November 3, 2016 By: /s/ Mark A. Hughes  
Date Treasurer and Chief Financial Officer