

CITIZENS & NORTHERN CORP  
Form 10-Q  
August 06, 2018

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 **June 30, 2018**

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**

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(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 x No "

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definition of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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

Emerging growth company "

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

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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) 12,281,924 Shares Outstanding on July 30, 2018

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

**CITIZENS & NORTHERN CORPORATION**

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**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****ITEM 1. FINANCIAL STATEMENTS****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share and Per Share Data) (Unaudited)**

|  | June 30,<br>2018    | December 31,<br>2017 |
|--|---------------------|----------------------|
| <b>ASSETS</b>  |                     |                      |
| Cash and due from banks:   |                     |                      |
| Noninterest-bearing  | \$ 19,720           | \$ 25,664            |
| Interest-bearing   | 31,755              | 14,580               |
| Total cash and due from banks  | 51,475              | 40,244               |
| Available-for-sale debt securities, at fair value  | 348,044             | 355,937              |
| Marketable equity security   | 948                 | 971                  |
| Loans held for sale  | 177                 | 765                  |
| <br>   |                     |                      |
| Loans receivable   | 818,647             | 815,713              |
| Allowance for loan losses  | (8,831 )            | (8,856 )             |
| Loans, net   | 809,816             | 806,857              |
| <br>   |                     |                      |
| Bank-owned life insurance  | 18,835              | 20,083               |
| Accrued interest receivable  | 4,042               | 4,048                |
| Bank premises and equipment, net   | 15,017              | 15,432               |
| Foreclosed assets held for sale  | 2,897               | 1,598                |
| Deferred tax asset, net  | 4,304               | 3,289                |
| Intangible assets - Goodwill and core deposit intangibles  | 11,952              | 11,954               |
| Other assets   | 16,500              | 15,781               |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,284,007</b> | <b>\$ 1,276,959</b>  |
| <br>   |                     |                      |
| <b>LIABILITIES</b>   |                     |                      |
| Deposits:  |                     |                      |
| Noninterest-bearing  | \$ 248,502          | \$ 241,214           |
| Interest-bearing   | 792,397             | 767,235              |
| Total deposits   | 1,040,899           | 1,008,449            |
| Short-term borrowings  | 17,169              | 61,766               |
| Long-term borrowings   | 27,054              | 9,189                |
| Accrued interest and other liabilities   | 9,706               | 9,112                |
| <b>TOTAL LIABILITIES</b>   | <b>1,094,828</b>    | <b>1,088,516</b>     |
| <br>   |                     |                      |
| <b>STOCKHOLDERS' EQUITY</b>  |                     |                      |
| Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; no shares issued                                       | 0                   | 0                    |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares; issued 12,655,171; outstanding 12,280,538 at June 30, 2018 and 12,214,525 December 31, | 12,655              | 12,655               |

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|  |                    |                     |
|--|--------------------|---------------------|
| 2017   |                    |                     |
| Paid-in capital  | 71,947             | 72,035              |
| Retained earnings  | 118,012            | 113,608             |
| Treasury stock, at cost; 374,633 shares at June 30, 2018 and 440,646 shares at December 31, 2017 | (7,096 )           | (8,348 )            |
| Accumulated other comprehensive loss   | (6,339 )           | (1,507 )            |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  | <b>189,179</b>     | <b>188,443</b>      |
| <b>TOTAL LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>  | <b>\$1,284,007</b> | <b>\$ 1,276,959</b> |

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****Consolidated Statements of Income****(In Thousands Except Per Share Data) (Unaudited)**

|  | 3 Months Ended   |                  | 6 Months Ended   |                  |
|--|------------------|------------------|------------------|------------------|
|  | June 30,<br>2018 | June 30,<br>2017 | June 30,<br>2018 | June 30,<br>2017 |
| <b>INTEREST INCOME</b>   |                  |                  |                  |                  |
| Interest and fees on loans:  |                  |                  |                  |                  |
| Taxable  | \$9,575          | \$8,609          | \$18,776         | \$16,983         |
| Tax-exempt   | 560              | 501              | 1,116            | 951              |
| Interest on mortgages held for sale                                | 4                | 6                | 6                | 10               |
| Interest on balances with depository institutions                  | 96               | 41               | 146              | 73               |
| Income from available-for-sale debt securities:                    |                  |                  |                  |                  |
| Taxable  | 1,381            | 1,352            | 2,744            | 2,755            |
| Tax-exempt   | 712              | 826              | 1,425            | 1,670            |
| Dividends on marketable equity security                            | 6                | 5                | 11               | 10               |
| Total interest and dividend income                                 | 12,334           | 11,340           | 24,224           | 22,452           |
| <b>INTEREST EXPENSE</b>  |                  |                  |                  |                  |
| Interest on deposits   | 879              | 575              | 1,608            | 1,096            |
| Interest on short-term borrowings                                  | 82               | 45               | 281              | 122              |
| Interest on long-term borrowings                                   | 118              | 358              | 183              | 713              |
| Total interest expense   | 1,079            | 978              | 2,072            | 1,931            |
| Net interest income  | 11,255           | 10,362           | 22,152           | 20,521           |
| (Credit) provision for loan losses                                 | (20 )            | 4                | 272              | 456              |
| Net interest income after (credit) provision for loan losses       | 11,275           | 10,358           | 21,880           | 20,065           |
| <b>NONINTEREST INCOME</b>  |                  |                  |                  |                  |
| Trust and financial management revenue                             | 1,526            | 1,497            | 2,948            | 2,677            |
| Brokerage revenue  | 271              | 208              | 483              | 364              |
| Insurance commissions, fees and premiums                           | 13               | 31               | 57               | 72               |
| Service charges on deposit accounts                                | 1,302            | 1,112            | 2,506            | 2,213            |
| Service charges and fees   | 82               | 86               | 168              | 166              |
| Interchange revenue from debit card transactions                   | 641              | 568              | 1,220            | 1,088            |
| Net gains from sale of loans                                       | 166              | 188              | 350              | 354              |
| Loan servicing fees, net   | 61               | 55               | 189              | 127              |
| Increase in cash surrender value of life insurance                 | 98               | 94               | 195              | 184              |
| Other noninterest income   | 529              | 267              | 979              | 725              |
| Sub-total  | 4,689            | 4,106            | 9,095            | 7,970            |
| Gain on restricted equity security                                 | 1,750            | 0                | 1,750            | 0                |
| Realized (losses) gains on available-for-sale debt securities, net | (282 )           | 107              | (282 )           | 252              |
| Total noninterest income   | 6,157            | 4,213            | 10,563           | 8,222            |
| <b>NONINTEREST EXPENSE</b>   |                  |                  |                  |                  |
| Salaries and wages   | 4,193            | 3,972            | 8,317            | 7,840            |
| Pensions and other employee benefits                               | 1,200            | 1,137            | 2,810            | 2,661            |
| Occupancy expense, net   | 613              | 600              | 1,250            | 1,178            |

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|  |         |         |          |         |
|--|---------|---------|----------|---------|
| Furniture and equipment expense                  | 313     | 315     | 584      | 628     |
| Data processing expenses                         | 694     | 615     | 1,335    | 1,190   |
| Automated teller machine and interchange expense | 319     | 305     | 641      | 599     |
| Pennsylvania shares tax                          | 336     | 336     | 672      | 672     |
| Professional fees                                | 279     | 188     | 555      | 375     |
| Telecommunications                               | 157     | 132     | 390      | 266     |
| Directors' fees                                  | 168     | 186     | 352      | 371     |
| Other noninterest expense                        | 1,412   | 1,290   | 2,673    | 2,594   |
| Total noninterest expense                        | 9,684   | 9,076   | 19,579   | 18,374  |
| Income before income tax provision               | 7,748   | 5,495   | 12,864   | 9,913   |
| Income tax provision                             | 1,377   | 1,374   | 2,118    | 2,358   |
| NET INCOME                                       | \$6,371 | \$4,121 | \$10,746 | \$7,555 |
| EARNINGS PER COMMON SHARE - BASIC                | \$0.52  | \$0.34  | \$0.88   | \$0.62  |
| EARNINGS PER COMMON SHARE - DILUTED              | \$0.52  | \$0.34  | \$0.87   | \$0.62  |

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



**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****Consolidated Statements of Comprehensive Income****(In Thousands) (Unaudited)**

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2018                           | 2017     | 2018                         | 2017     |
| Net income   | \$ 6,371                       | \$ 4,121 | \$ 10,746                    | \$ 7,555 |
| Unrealized (losses) gains on available-for-sale securities:  |                                |          |                              |          |
| Unrealized holding (losses) gains on available-for-sale securities   | (1,292 )                       | 1,644    | (6,131 )                     | 2,280    |
| Reclassification adjustment for losses (gains) realized in income  | 282                            | (107 )   | 282                          | (252 )   |
| Other comprehensive (loss) gain on available-for-sale securities   | (1,010 )                       | 1,537    | (5,849 )                     | 2,028    |
| Unfunded pension and postretirement obligations:   |                                |          |                              |          |
| Changes from plan amendments and actuarial gains and losses included in accumulated other comprehensive gain | 0                              | 0        | 93                           | 166      |
| Amortization of prior service cost and net actuarial loss included in net periodic benefit cost              | (5 )                           | (6 )     | (10 )                        | (12 )    |
| Other comprehensive (loss) gain on unfunded retirement obligations   | (5 )                           | (6 )     | 83                           | 154      |
| Other comprehensive (loss) income before income tax  | (1,015 )                       | 1,531    | (5,766 )                     | 2,182    |
| Income tax related to other comprehensive loss (income)  | 214                            | (536 )   | 1,211                        | (764 )   |
| Net other comprehensive (loss) income  | (801 )                         | 995      | (4,555 )                     | 1,418    |
| Comprehensive income   | \$ 5,570                       | \$ 5,116 | \$ 6,191                     | \$ 8,973 |

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In Thousands) (Unaudited)**

|   | 6 Months Ended   |                  |
|---|------------------|------------------|
|   | June 30,<br>2018 | June 30,<br>2017 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                  |                  |
| Net income  | \$10,746         | \$7,555          |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Provision for loan losses   | 272              | 456              |
| Realized losses (gains) on available-for-sale securities, net                     | 282              | (252 )           |
| Unrealized loss on marketable equity security                                     | 23               | 0                |
| Gain on restricted equity security  | (1,750 )         | 0                |
| Depreciation expense  | 850              | 826              |
| Accretion and amortization on securities, net                                     | 512              | 583              |
| Increase in cash surrender value of life insurance                                | (195 )           | (184 )           |
| Stock-based compensation and other expense  | 338              | 322              |
| Deferred income taxes   | 196              | 411              |
| Decrease in fair value of servicing rights  | 26               | 78               |
| Gains on sales of loans, net  | (350 )           | (354 )           |
| Origination of loans for sale   | (10,730)         | (12,741)         |
| Proceeds from sales of loans  | 11,571           | 11,434           |
| Increase in accrued interest receivable and other assets                          | (454 )           | (1,568 )         |
| Decrease in accrued interest payable and other liabilities                        | 677              | 921              |
| Other   | 193              | 104              |
| Net Cash Provided by Operating Activities   | 12,207           | 7,591            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                  |                  |
| Proceeds from maturities of certificates of deposit                               | 820              | 348              |
| Purchase of certificates of deposit   | (350 )           | (100 )           |
| Proceeds from sales of available-for-sale securities                              | 0                | 14,373           |
| Proceeds from calls and maturities of available-for-sale securities               | 23,605           | 27,529           |
| Purchase of available-for-sale securities   | (22,355)         | (9,376 )         |
| Redemption of Federal Home Loan Bank of Pittsburgh stock                          | 4,020            | 4,054            |
| Purchase of Federal Home Loan Bank of Pittsburgh stock                            | (2,542 )         | (3,206 )         |
| Net increase in loans   | (5,712 )         | (28,753)         |
| Proceeds from bank owned life insurance   | 1,443            | 0                |
| Purchase of premises and equipment  | (687 )           | (939 )           |
| Proceeds from sale of foreclosed assets   | 1,243            | 644              |
| Other   | 84               | 75               |
| Net Cash (Used in) Provided by Investing Activities                               | (431 )           | 4,649            |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                  |                  |
| Net increase in deposits  | 32,450           | 13,419           |
| Net decrease in short-term borrowings   | (44,597)         | (17,300)         |
| Proceeds from long-term borrowings  | 18,000           | 0                |

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|  |          |          |
|--|----------|----------|
| Repayments of long-term borrowings           | (135 )   | (133 )   |
| Sale of treasury stock                       | 65       | 81       |
| Common dividends paid                        | (5,858 ) | (5,525 ) |
| Net Cash Used in Financing Activities        | (75 )    | (9,458 ) |
| INCREASE IN CASH AND CASH EQUIVALENTS        | 11,701   | 2,782    |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 37,004   | 28,621   |
| CASH AND CASH EQUIVALENTS, END OF PERIOD     | \$48,705 | \$31,403 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

|  |         |         |
|--|---------|---------|
| Assets acquired through foreclosure of real estate loans | \$2,486 | \$608   |
| Accrued purchase of available-for-sale debt security     | \$0     | \$505   |
| Interest paid  | \$2,011 | \$1,926 |
| Income taxes paid  | \$1,275 | \$1,635 |

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****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<br>(Loss) | Treasury<br>Stock | Total      |
|--|------------------|--------------------|-----------------|--------------------|----------------------|---|-------------------|------------|
| Six Months Ended June<br>30, 2018  |                  |                    |                 |                    |                      |   |                   |            |
| Balance, December 31,<br>2017  | 12,655,171       | 440,646            | \$ 12,655       | \$ 72,035          | \$ 113,608           | (\$ 1,507 )   | (\$ 8,348 )       | \$ 188,443 |
| Impact of change in<br>enacted income tax rate<br>(a)  |                  |                    |                 |                    | 325                  | (325 )  |                   | 0          |
| Impact of change in<br>method of<br>premium amortization<br>of callable debt<br>securities (b) |                  |                    |                 |                    | (26 )                | 26  |                   | 0          |
| Impact of change in<br>method of accounting<br>for marketable equity<br>security (c)           |                  |                    |                 |                    | (22 )                | 22  |                   | 0          |
| Net income   |                  |                    |                 |                    | 10,746               |   |                   | 10,746     |
| Other comprehensive<br>loss, net   |                  |                    |                 |                    |                      | (4,555 )  |                   | (4,555 )   |
| Cash dividends declared<br>on common stock,<br>\$0.54 per share                                |                  |                    |                 |                    | (6,619 )             |   |                   | (6,619 )   |
| Shares issued for<br>dividend<br>reinvestment Plan   |                  | (31,572 )          |                 | 163                |                      |   | 598               | 761        |
| Shares issued from<br>treasury and<br>redeemed related to<br>exercise of stock<br>options      |                  | (7,417 )           |                 | (75 )              |                      |   | 140               | 65         |
| Restricted stock granted   |                  | (34,552 )          |                 | (655 )             |                      |   | 655               | 0          |
| Forfeiture of restricted<br>stock  |                  | 7,528              |                 | 141                |                      |   | (141 )            | 0          |
|  |                  |                    |                 | 338                |                      |   |                   | 338        |

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|   |            |           |           |           |            |             |              |            |  |
|---|------------|-----------|-----------|-----------|------------|-------------|--------------|------------|--|
| Stock-based compensation expense  |            |           |           |           |            |             |              |            |  |
| Balance, June 30, 2018  | 12,655,171 | 374,633   | \$ 12,655 | \$ 71,947 | \$ 118,012 | \$ (6,339 ) | \$ (7,096 )  | \$ 189,179 |  |
| Six Months Ended June 30, 2017  |            |           |           |           |            |             |              |            |  |
| Balance, December 31, 2016  | 12,655,171 | 541,943   | \$ 12,655 | \$ 71,730 | \$ 112,790 | (\$ 898 )   | (\$ 10,269 ) | \$ 186,008 |  |
| Net income  |            |           |           |           | 7,555      |             |              | 7,555      |  |
| Other comprehensive income, net   |            |           |           |           |            | 1,418       |              | 1,418      |  |
| Cash dividends declared on common stock, \$0.52 per share                     |            |           |           |           | (6,279 )   |             |              | (6,279 )   |  |
| Shares issued for dividend reinvestment Plan                                  |            | (31,913 ) |           | 148       |            |             | 606          | 754        |  |
| Shares issued from treasury and redeemed related to exercise of stock options |            | (4,578 )  |           | (4 )      |            |             | 85           | 81         |  |
| Restricted stock granted  |            | (30,782 ) |           | (583 )    |            |             | 583          | 0          |  |
| Forfeiture of restricted stock  |            | 3,808     |           | 71        |            |             | (71 )        | 0          |  |
| Stock-based compensation expense  |            |           |           | 322       |            |             |              | 322        |  |
| Balance, June 30, 2017  | 12,655,171 | 478,478   | \$ 12,655 | \$ 71,684 | \$ 114,066 | \$ 520      | (\$ 9,066 )  | \$ 189,859 |  |

As described in more detail in the Recent Accounting Pronouncements - Adopted section of Note 1, this (a) reclassification resulted from adoption of Accounting Standards Update (ASU) 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, effective January 1, 2018.

As described in more detail in the Recent Accounting Pronouncements - Adopted section of Note 1, this (b) reclassification resulted from adoption of ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), effective January 1, 2018.

As described in more detail in the Recent Accounting Pronouncements - Adopted section of Note 1, this (c) reclassification resulted from adoption of ASU 2016-01, Recognition and Measurement of Financial Assets and Liabilities, effective January 1, 2018.

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

**Notes to Unaudited Consolidated Financial Statements**

**1. BASIS OF INTERIM PRESENTATION AND STATUS OF RECENT ACCOUNTING PRONOUNCEMENTS**

The consolidated financial statements include the accounts of Citizens & Northern Corporation and its subsidiaries, Citizens & Northern Bank (“C&N Bank”), Bucktail Life Insurance Company and Citizens & Northern Investment Corporation (collectively, “Corporation”), as well as C&N Bank’s wholly-owned subsidiary, C&N Financial Services Corporation. In December 2017, C&N Bank established a new entity, Northern Tier Holding LLC, for the purpose of acquiring, holding and disposing of real property acquired by the Bank. C&N Bank is the sole member of Northern Tier Holding LLC. All material intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2017, 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 2017 information has been reclassified for consistency with the 2018 presentation.

Operating results reported for the three-month and six-month periods ended June 30, 2018 might not be indicative of the results for the year ending December 31, 2018. The Corporation evaluates subsequent events through the date of filing with the Securities and Exchange Commission.

**RECENT ACCOUNTING PRONOUNCEMENTS**

The Financial Accounting Standards Board (FASB) issues Accounting Standards Updates (ASUs) to the FASB Accounting Standards Codification (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.

**Recent Accounting Pronouncements - Adopted**

Effective January 1, 2018, the Corporation adopted ASU 2014-09, Revenue from Contracts with Customers (Topic 606). Under the ASU, as modified by subsequent ASUs, revenue is recognized when a customer obtains control of promised services in an amount that reflects the consideration the entity expects to receive in exchange for those services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The Corporation applied the five-step method outlined in the ASU to all revenue streams scoped-in by the ASU and elected the modified retrospective implementation method. Substantially all of the Corporation's interest income and certain noninterest income were not impacted by the adoption of this ASU because the revenue from those contracts with customers is covered by other guidance in U.S. GAAP. The Corporation's largest sources of noninterest revenue which are subject to the guidance include Trust and financial management revenue, service charges on deposit accounts and interchange revenue from debit card transactions. Adoption of ASU 2014-09 did not change the timing and pattern of the Corporation's revenue recognition related to scoped-in noninterest income. New disclosures required by the ASU have been included in Note 13.

In February 2018, the FASB issued ASU 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which permits, but does not require, entities to reclassify tax effects stranded in accumulated other comprehensive income resulting from the Tax Cuts and Jobs Act of 2017 to retained earnings. Companies that elect to reclassify these amounts must reclassify stranded tax effects for all items accounted for in accumulated other comprehensive income. The Corporation elected early adoption and adopted this standard update, effective January 1, 2018. The Corporation's stranded tax effects were related to valuation of the net deferred tax asset attributable to items of accumulated other comprehensive income (loss), which are unrealized gains (losses) on available-for-sale securities and unfunded defined benefit plan obligations. Adoption resulted in a reclassification between two categories of stockholders' equity at January 1, 2018, with an increase of \$325,000 in retained earnings and a decrease in accumulated other comprehensive loss for the same amount (no net change in stockholders' equity).

Effective January 1, 2018, the Corporation elected early adoption of ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20). This Update shortens the amortization period for certain callable debt securities held at a premium. Discounts will continue to be amortized to maturity. Adoption resulted in a reduction in retained earnings and corresponding increase in accumulated other comprehensive loss (no net change in stockholders' equity) of \$26,000 at January 1, 2018 for the cumulative after-tax impact of the change in accounting for debt securities held as of that date.

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Effective January 1, 2018, the Corporation adopted ASU 2016-01, Recognition and Measurement of Financial Assets and Liabilities. The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. ASU 2016-01 was effective for the Corporation on January 1, 2018 and resulted in the following changes:

A marketable equity security previously included in available-for-sale securities on the consolidated balance sheets is presented as a separate asset.

Changes in the fair value of the marketable equity security are captured in the consolidated statements of income.

Retained earnings was reduced and a corresponding increase in accumulated other comprehensive loss was recognized (no net change in stockholders' equity) of \$22,000 at January 1, 2018 for the after-tax impact of the change in accounting for the unrealized loss on the marketable equity security.

As described in more detail in Note 6, in the second quarter 2018, an unrealized gain of \$866,000 (pre-tax) was recognized in the unaudited, consolidated statements of income on a restricted equity security (Visa Class B stock). As required by ASU 2016-01, the Corporation considered the pricing of observable transactions in determining the carrying value of this equity security that does not have a readily determinable fair value. Accordingly, the Corporation's second quarter 2018 gain included the realized portion related to 10,000 shares sold in June 2018 and an unrealized portion based on the price per share of that sale. At June 30, 2018, the balance of other assets in the unaudited, consolidated balance sheet included a total of \$1,750,000 associated with the Visa Class B shares, including a receivable of \$884,000 from the sale of 10,000 shares and \$866,000 from the carrying value of the remaining 9,789 shares.

Adoption of ASU 2016-01 also resulted in the use of an exit price to determine the fair value of financial instruments not measured at fair value in the consolidated balance sheets. Further information regarding valuation of financial instruments is provided in Note 5.

**Recently Issued But Not Yet Effective Accounting Pronouncements**

ASU 2016-02, Leases (Topic 842) changes current GAAP by requiring that lease assets and liabilities arising from operating leases be recognized on the balance sheet. In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, Leases, amending narrow aspects of Topic 842. 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. 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 will become effective for the Corporation for annual and interim periods beginning in the first quarter 2019. Adoption of Topic 842 is not expected to have a material impact on the Corporation's consolidated financial statements. The



Corporation leases certain properties and equipment under operating leases that will result in the recognition of lease assets and lease liabilities on the consolidated balance sheet under Topic 842; however, the majority of the Corporation's properties and equipment are owned, not leased.

ASU 2016-13, Financial Instruments-Credit Losses (Topic 326), changes accounting for credit losses on loans receivable and debt securities from an incurred loss methodology to an expected credit loss methodology. Among other things, ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Accordingly, ASU 2016-13 requires the use of forward-looking information to form credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, though the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on debt securities and purchased financial assets with credit deterioration. The amendments in ASU 2016-13 will be effective for the Corporation beginning in the first quarter 2020. Earlier adoption is permitted beginning in the first quarter 2019; however, the Corporation does not currently plan to early adopt the ASU. The Corporation has formed a cross functional management team that is assessing alternative loss estimation methodologies and the Corporation's data and system needs in order to evaluate the impact that adoption of this standard will have on the Corporation's financial condition and results of operations. The Corporation 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.

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ASU 2017-04, Intangibles – Goodwill and Other (Topic 350) simplifies the accounting for goodwill impairment. This guidance, among other things, removes step 2 of the goodwill impairment test thus eliminating the need to determine the fair value of individual assets and liabilities of the reporting unit. Upon adoption of this ASU, goodwill impairment will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. This may result in more or less impairment being recognized than under current guidance. This Update will become effective for the Corporation's annual and interim goodwill impairment tests beginning in the first quarter 2020. The Corporation does not expect adoption of this ASU to have a material impact on its consolidated financial statements.

**2. PER SHARE DATA**

Basic earnings per common share are calculated using the two-class method to determine income attributable to common shareholders. Unvested restricted stock awards that contain nonforfeitable rights to dividends are considered participating securities under the two-class method. Distributed dividends and an allocation of undistributed net income to participating securities reduce the amount of income attributable to common shareholders. Income attributable to common shareholders is then divided by weighted-average common shares outstanding for the period to determine basic earnings per common share.

Diluted earnings per common share are calculated under the more dilutive of either the treasury method or the two-class method. Diluted earnings per common 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.

|  | 3 Months Ended   |                  | 6 Months Ended   |                  |
|--|------------------|------------------|------------------|------------------|
|  | June 30,<br>2018 | June 30,<br>2017 | June 30,<br>2018 | June 30,<br>2017 |
| <b>Basic</b>   |                  |                  |                  |                  |
| Net income   | \$6,371,000      | \$4,121,000      | \$10,746,000     | \$7,555,000      |
| Less: Dividends and undistributed earnings allocated to participating securities | (32,000 )        | (21,000 )        | (55,000 )        | (39,000 )        |
| Net income attributable to common shares   | \$6,339,000      | \$4,100,000      | \$10,691,000     | \$7,516,000      |
| Basic weighted-average common shares outstanding                                 | 12,210,902       | 12,106,008       | 12,200,245       | 12,095,926       |
| Basic earnings per common share (a)  | \$0.52           | \$0.34           | \$0.88           | \$0.62           |
| <b>Diluted</b>   |                  |                  |                  |                  |
| Net income attributable to common shares   | \$6,339,000      | \$4,100,000      | \$10,691,000     | \$7,516,000      |
| Basic weighted-average common shares outstanding                                 | 12,210,902       | 12,106,008       | 12,200,245       | 12,095,926       |
|  | 37,243           | 38,698           | 36,273           | 42,263           |

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Dilutive effect of potential common stock arising from  
stock options

|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Diluted weighted-average common shares outstanding       | 12,248,145 | 12,144,706 | 12,236,518 | 12,138,189 |
| Diluted earnings per common share (a)                    | \$0.52     | \$0.34     | \$0.87     | \$0.62     |
| Weighted-average nonvested restricted shares outstanding | 61,172     | 62,080     | 63,175     | 63,633     |

(a) Basic and diluted earnings per share under the two-class method are determined on net income reported on the consolidated statements of income, less earnings allocated to nonvested restricted shares with nonforfeitable dividends (participating securities).

Anti-dilutive stock options are excluded from net income per share calculations. There were no anti-dilutive instruments in the three-month or six-month periods ended June 30, 2018 and 2017.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****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 (loss). The components of other comprehensive income (loss), and the related tax effects, are as follows:

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| Six Months Ended June 30, 2018   |                      |                         |                      |
| Unrealized losses on available-for-sale securities:  |                      |                         |                      |
| Unrealized holding losses on available-for-sale securities   | \$ (6,131 )          | \$ 1,287                | \$ (4,844 )          |
| Reclassification adjustment for losses realized in income  | 282                  | (59 )                   | 223                  |
| Other comprehensive loss on available-for-sale securities  | (5,849 )             | 1,228                   | (4,621 )             |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income | 93                   | (19 )                   | 74                   |
| Amortization of prior service cost and net actuarial loss included in net periodic benefit cost    | (10 )                | 2                       | (8 )                 |
| Other comprehensive income on unfunded retirement obligations                                      | 83                   | (17 )                   | 66                   |
| Total other comprehensive loss   | \$ (5,766 )          | \$ 1,211                | \$ (4,555 )          |

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| Six Months Ended June 30, 2017   |                      |                         |                      |
| Unrealized gains on available-for-sale securities:   |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities  | \$ 2,280             | (\$ 798 )               | \$ 1,482             |
| Reclassification adjustment for (gains) realized in income   | (252 )               | 88                      | (164 )               |
| Other comprehensive income on available-for-sale securities  | 2,028                | (710 )                  | 1,318                |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income | 166                  | (58 )                   | 108                  |
| Amortization of prior service cost and net actuarial loss included in net periodic benefit cost    | (12 )                | 4                       | (8 )                 |
| Other comprehensive income on unfunded retirement obligations                                      | 154                  | (54 )                   | 100                  |
| Total other comprehensive income   | \$ 2,182             | (\$ 764 )               | \$ 1,418             |

| (In Thousands) | Before-Tax | Net-of-Tax |
|----------------|------------|------------|
|----------------|------------|------------|

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|  | Amount      | Income<br>Tax<br>Effect | Amount      |
|--|-------------|-------------------------|-------------|
| Three Months Ended June 30, 2018   |             |                         |             |
| Unrealized losses on available-for-sale securities:  |             |                         |             |
| Unrealized holding losses on available-for-sale securities   | \$ (1,292 ) | \$ 272                  | \$ (1,020 ) |
| Reclassification adjustment for losses realized in income  | 282         | (59 )                   | 223         |
| Other comprehensive loss on available-for-sale securities  | (1,010 )    | 213                     | (797 )      |
| Unfunded pension and postretirement obligations:   |             |                         |             |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income | 0           | 0                       | 0           |
| Amortization of prior service cost and net actuarial loss included in net periodic benefit cost    | (5 )        | 1                       | (4 )        |
| Other comprehensive loss on unfunded retirement obligations  | (5 )        | 1                       | (4 )        |
| Total other comprehensive loss   | \$ (1,015 ) | \$ 214                  | \$ (801 )   |

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| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| Three Months Ended June 30, 2017   |                      |                         |                      |
| Unrealized gains on available-for-sale securities:   |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities  | \$ 1,644             | (\$ 575 )               | \$ 1,069             |
| Reclassification adjustment for (gains) realized in income   | (107 )               | 37                      | (70 )                |
| Other comprehensive income on available-for-sale securities  | 1,537                | (538 )                  | 999                  |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income | 0                    | 0                       | 0                    |
| Amortization of prior service cost and net actuarial loss included in net periodic benefit cost    | (6 )                 | 2                       | (4 )                 |
| Other comprehensive loss on unfunded retirement obligations  | (6 )                 | 2                       | (4 )                 |
| Total other comprehensive income   | \$ 1,531             | \$ (536 )               | \$ 995               |

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

| (In Thousands)   | Unrealized<br>(Losses)<br>Gains<br>on<br>Securities | Unfunded<br>Retirement<br>Obligations | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|--|---|---------------------------------------|--|
| Six Months Ended June 30, 2018   |   |                                       |  |
| Balance, beginning of period   | \$ (1,566 )   | \$ 59                                 | \$ (1,507 )  |
| Impact of change in enacted income tax rate  | (337 )  | 12                                    | (325 )   |
| Impact of change in the method of premium amortization of callable debt securities | 26  | 0                                     | 26   |
| Impact of change in the method of accounting for marketable equity security        | 22  | 0                                     | 22   |
| Other comprehensive (loss) income during six months ended June 30, 2018            | (4,621 )  | 66                                    | (4,555 )   |
| Balance, end of period   | \$ (6,476 )   | \$ 137                                | \$ (6,339 )  |
| Six Months Ended June 30, 2017   |   |                                       |  |
| Balance, beginning of period   | \$ (949 )   | \$ 51                                 | \$ (898 )  |
| Other comprehensive income during six months ended June 30, 2017                   | 1,318   | 100                                   | 1,418  |
| Balance, end of period   | \$ 369  | \$ 151                                | \$ 520   |
| Three Months Ended June 30, 2018   |   |                                       |  |
| Balance, beginning of period   | \$ (5,679 )   | \$ 141                                | \$ (5,538 )  |
| Other comprehensive (loss) during three months ended June 30, 2018                 | (797 )  | (4 )                                  | (801 )   |

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|   |             |        |             |
|---|-------------|--------|-------------|
| Balance, end of period  | \$ (6,476 ) | \$ 137 | \$ (6,339 ) |
| Three Months Ended June 30, 2017  |             |        |             |
| Balance, beginning of period  | \$ (630 )   | \$ 155 | \$ (475 )   |
| Other comprehensive income (loss) during three months ended June 30, 2017 | 999         | (4 )   | 995         |
| Balance, end of period  | \$ 369      | \$ 151 | \$ 520      |

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

For the Six Months Ended June 30, 2018

(In Thousands)

| Details about Accumulated Other<br>Comprehensive Loss Components     | Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Affected Line Item in the Consolidated<br>Statements of Income |
|--|---|--|
| Unrealized gains and losses on<br>available-for-sale securities      | \$ 282  | Realized losses on available-for-sale debt<br>securities, net  |
|  | (59   | ) Income tax provision   |
|  | 223   | Net of tax   |
| Amortization of defined benefit pension and<br>postretirement items: |   |  |
| Prior service cost   | (16   | ) Other noninterest expense                                    |
| Actuarial loss   | 6   | Other noninterest expense                                      |
|  | (10   | ) Total before tax   |
|  | 2   | Income tax provision   |
|  | (8  | ) Net of tax   |
| Total reclassifications for the period                               | \$ 215  |  |

For the Six Months Ended June 30, 2017

(In Thousands)

| Details about Accumulated Other<br>Comprehensive Loss Components     | Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Affected Line Item in the Consolidated<br>Statements of Income |
|--|---|--|
| Unrealized gains and losses on<br>available-for-sale securities      | \$ (252   | ) Realized gains on available-for-sale debt<br>securities, net |
|  | 88  | Income tax provision   |
|  | (164  | ) Net of tax   |
| Amortization of defined benefit pension and<br>postretirement items: |   |  |
| Prior service cost   | (15   | ) Other noninterest expense                                    |
| Actuarial loss   | 3   | Other noninterest expense                                      |
|  | (12   | ) Total before tax   |
|  | 4   | Income tax provision   |
|  | (8  | ) Net of tax   |
| Total reclassifications for the period                               | \$ (172   | )  |



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For the Three Months Ended June 30, 2018  
(In Thousands)

|  | Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Affected Line Item in the Consolidated<br>Statements of Income |
|--|---|--|
| Details about Accumulated Other<br>Comprehensive Loss Components     |   |  |
| Unrealized gains and losses on<br>available-for-sale securities      | \$ 282  | Realized losses on available-for-sale debt<br>securities, net  |
|  | (59   | ) Income tax provision   |
|  | 223   | Net of tax   |
| Amortization of defined benefit pension and<br>postretirement items: |   |  |
| Prior service cost   | (8  | ) Other noninterest expense                                    |
| Actuarial loss   | 3   | Other noninterest expense                                      |
|  | (5  | ) Total before tax   |
|  | 1   | Income tax provision   |
|  | (4  | ) Net of tax   |
| Total reclassifications for the period                               | \$ 219  |  |

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For the Three Months Ended June 30, 2017  
(In Thousands)

|  | Reclassified<br>from  | Affected Line Item in the Consolidated                       |
|--|-----------------------|--|
| Details about Accumulated Other                                      | Accumulated<br>Other  | Statements of Income   |
| Comprehensive Loss Components  | Comprehensive<br>Loss | Realized gains on available-for-sale debt<br>securities, net |
| Unrealized gains and losses on<br>available-for-sale securities      | \$ (107 )             | Income tax provision   |
|  | 37                    | Net of tax   |
|  | (70 )                 |  |
| Amortization of defined benefit pension and<br>postretirement items: |                       |  |
| Prior service cost   | (7 )                  | Other noninterest expense                                    |
| Actuarial loss   | 1                     | Other noninterest expense                                    |
|  | (6 )                  | Total before tax   |
|  | 2                     | Income tax provision   |
|  | (4 )                  | Net of tax   |
| Total reclassifications for the period                               | \$ (74 )              |  |

**4. CASH AND DUE FROM BANKS**

Cash and due from banks at June 30, 2018 and December 31, 2017 include the following:

| (In thousands)                | June 30,<br>2018 | Dec. 31,<br>2017 |
|-------------------------------|------------------|------------------|
| Cash and cash equivalents     | \$48,705         | \$37,004         |
| Certificates of deposit       | 2,770            | 3,240            |
| Total cash and due from banks | \$51,475         | \$40,244         |

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 \$14,232,000 at June 30, 2018 and \$17,178,000 at December 31, 2017.

## 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.

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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 June 30, 2018 and December 31, 2017, assets measured at fair value and the valuation methods used are as follows:

| (In Thousands)  | June 30, 2018   |  |                                     | Total<br>Fair<br>Value |
|---|---|--|-------------------------------------|------------------------|
|   | 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) |                        |
| Recurring fair value measurements   |   |  |                                     |                        |
| <b>AVAILABLE-FOR-SALE DEBT SECURITIES:</b>  |   |  |                                     |                        |
| Obligations of U.S. Government agencies   | \$ 0  | \$7,779                                    | \$ 0                                | \$7,779                |
| Obligations of states and political subdivisions:   |   |  |                                     |                        |
| Tax-exempt  | 0   | 101,700                                    | 0                                   | 101,700                |
| Taxable   | 0   | 26,066                                     | 0                                   | 26,066                 |
| Mortgage-backed securities issued or guaranteed by U.S.<br>Government agencies or sponsored agencies: |   |  |                                     |                        |
| Residential pass-through securities   | 0   | 58,330                                     | 0                                   | 58,330                 |
| Residential collateralized mortgage obligations   | 0   | 121,933                                    | 0                                   | 121,933                |
| Commercial mortgage-backed securities   | 0   | 32,236                                     | 0                                   | 32,236                 |
| Total available-for-sale debt securities  | 0   | 348,044                                    | 0                                   | 348,044                |
| Marketable equity security  | 948   | 0  | 0                                   | 948                    |
| Restricted equity security  | 0   | 0  | 866                                 | 866                    |
| Servicing rights  | 0   | 0  | 1,370                               | 1,370                  |
| Total recurring fair value measurements   | \$ 948  | \$348,044                                  | \$ 2,236                            | \$351,228              |
| Nonrecurring fair value measurements  |   |  |                                     |                        |
| Impaired loans with a valuation allowance   | \$ 0  | \$0  | \$ 3,652                            | \$3,652                |
| Valuation allowance   | 0   | 0  | (1,095)                             | (1,095)                |
| Impaired loans, net   | 0   | 0  | 2,557                               | 2,557                  |
| Foreclosed assets held for sale   | 0   | 0  | 2,897                               | 2,897                  |
| Total nonrecurring fair value measurements  | \$ 0  | \$0  | \$ 5,454                            | \$5,454                |

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| (In Thousands)  | Quoted<br>Prices<br>in Active<br>Markets<br>(Level 1) | December 31, 2017                          |                                     |                        |
|---|---|--|-------------------------------------|------------------------|
|   |   | 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 DEBT SECURITIES:</b>  |   |  |                                     |                        |
| Obligations of U.S. Government agencies   | \$ 0  | \$7,873                                    | \$ 0                                | \$7,873                |
| Obligations of states and political subdivisions:   |   |  |                                     |                        |
| Tax-exempt  | 0   | 105,111                                    | 0                                   | 105,111                |
| Taxable   | 0   | 25,573                                     | 0                                   | 25,573                 |
| Mortgage-backed securities issued or guaranteed by U.S.<br>Government agencies or sponsored agencies: |   |  |                                     |                        |
| Residential pass-through securities   | 0   | 52,347                                     | 0                                   | 52,347                 |
| Residential collateralized mortgage obligations   | 0   | 131,814                                    | 0                                   | 131,814                |
| Commercial mortgage-backed securities   | 0   | 33,219                                     | 0                                   | 33,219                 |
| Total available-for-sale debt securities  | 0   | 355,937                                    | 0                                   | 355,937                |
| Marketable equity security  | 971   | 0  | 0                                   | 971                    |
| Servicing rights  | 0   | 0  | 1,299                               | 1,299                  |
| Total recurring fair value measurements   | \$ 971  | \$355,937                                  | \$ 1,299                            | \$358,207              |
| Nonrecurring fair value measurements  |   |  |                                     |                        |
| Impaired loans with a valuation allowance   | \$ 0  | \$0  | \$ 3,776                            | \$3,776                |
| Valuation allowance   | 0   | 0  | (1,183 )                            | (1,183 )               |
| Impaired loans, net   | 0   | 0  | 2,593                               | 2,593                  |
| Foreclosed assets held for sale   | 0   | 0  | 1,598                               | 1,598                  |
| Total nonrecurring fair value measurements  | \$ 0  | \$0  | \$ 4,191                            | \$4,191                |

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 June 30, 2018 and December 31, 2017, 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>6/30/18<br>(In<br>Thousands) | Valuation<br>Technique | Unobservable<br>Input(s) | Method or Value As of<br>6/30/18          |
|-------|---|------------------------|--------------------------|---|
|       | \$ 1,370                                      |                        | Discount rate            | 13.00 % Rate used through modeling period |

Servicing  
rights

Discounted  
cash flow

|                   |         |   |  |
|-------------------|---------|---|--|
| Loan              |         |   |  |
| prepayment speeds | 119.00% |   | 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   |

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| Asset               | Fair Value at<br>12/31/17<br>(In<br>Thousands) | Valuation<br>Technique  | Unobservable<br>Input(s)     | Method or Value As of<br>12/31/17   |
|---------------------|--|-------------------------|------------------------------|---|
| Servicing<br>rights | \$ 1,299                                       | Discounted<br>cash flow | Discount rate                | 13.00 % Rate used through modeling period   |
|                     |  |                         | Loan<br>prepayment<br>speeds | 140.00% 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<br>on loans more than 30 days 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. Unrealized gains (losses) in fair value of servicing rights are included in Loan servicing fees, net, in the unaudited consolidated statements of income.

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

| (In Thousands)                                 | Three Months Ended June 30, 2018 |                     |          | Six Months Ended June 30, 2018   |                     |          |
|--|----------------------------------|---------------------|----------|----------------------------------|---------------------|----------|
|  | Restricted<br>Equity<br>Security | Servicing<br>Rights | Total    | Restricted<br>Equity<br>Security | Servicing<br>Rights | Total    |
| Balance, beginning of period                   | \$ 0                             | \$ 1,369            | \$ 1,369 | \$ 0                             | \$ 1,299            | \$ 1,299 |
| Issuances of servicing rights                  | 0                                | 47                  | \$ 47    | 0                                | 97                  | \$ 97    |
| Unrealized gains (losses) included in earnings | 866                              | (46 )               | \$ 820   | 866                              | (26 )               | \$ 840   |
| Balance, end of period                         | \$ 866                           | \$ 1,370            | \$ 2,236 | \$ 866                           | \$ 1,370            | \$ 2,236 |

| (In Thousands) | Three Months Ended June 30, 2017 |                     |       | Six Months Ended June 30, 2017   |                     |       |
|----------------|----------------------------------|---------------------|-------|----------------------------------|---------------------|-------|
|                | Restricted<br>Equity<br>Security | Servicing<br>Rights | Total | Restricted<br>Equity<br>Security | Servicing<br>Rights | Total |

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|  |      |          |          |      |          |          |
|--|------|----------|----------|------|----------|----------|
| Balance, beginning of period                   | \$ 0 | \$ 1,278 | \$ 1,278 | \$ 0 | \$ 1,262 | \$ 1,262 |
| Issuances of servicing rights                  | 0    | 49       | \$ 49    | 0    | 95       | \$ 95    |
| Unrealized gains (losses) included in earnings | 0    | (48 )    | (\$ 48 ) | 0    | (78 )    | (\$ 78 ) |
| Balance, end of period                         | \$ 0 | \$ 1,279 | \$ 1,279 | \$ 0 | \$ 1,279 | \$ 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. For commercial and industrial and agricultural loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging data or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.



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At June 30, 2018 and December 31, 2017, quantitative information regarding significant techniques and inputs used for nonrecurring fair value measurements using unobservable inputs (Level 3 methodologies) are as follows:

| <b>(In Thousands, Except Percentages)</b>      | Balance at | Valuation Allowance at | Fair Value at | Valuation Technique | Unobservable Inputs         | Weighted-Average Discount at |   |
|--|------------|------------------------|---------------|---------------------|-----------------------------|------------------------------|---|
| Asset  | 6/30/18    | 6/30/18                | 6/30/18       |                     |                             | 6/30/18                      |   |
| Impaired loans:                                |            |                        |               |                     |                             |                              |   |
| Residential mortgage loans - first liens       | \$ 512     | \$ 120                 | \$ 392        | Sales comparison    | Discount to appraised value | 26                           | % |
| Commercial:                                    |            |                        |               |                     |                             |                              |   |
| Commercial loans secured by real estate        | 2,573      | 850                    | 1,723         | Sales comparison    | Discount to appraised value | 16                           | % |
| Commercial and industrial                      | 75         | 75                     | 0             | Sales comparison    | Discount to appraised value | 100                          | % |
| Loans secured by farmland                      | 492        | 50                     | 442           | Sales comparison    | Discount to appraised value | 56                           | % |
| Total impaired loans                           | \$ 3,652   | \$ 1,095               | \$ 2,557      |                     |                             |                              |   |
| Foreclosed assets held for sale - real estate: |            |                        |               |                     |                             |                              |   |
| Residential (1-4 family)                       | \$ 412     | \$ 0                   | \$ 412        | Sales comparison    | Discount to appraised value | 31                           | % |
| Land   | 120        | 0                      | 120           | Sales comparison    | Discount to appraised value | 57                           | % |
| Commercial real estate                         | 2,365      | 0                      | 2,365         | Sales comparison    | Discount to appraised value | 34                           | % |
| Total foreclosed assets held for sale          | \$ 2,897   | \$ 0                   | \$ 2,897      |                     |                             |                              |   |

| <b>(In Thousands, Except Percentages)</b> | Balance at | Valuation Allowance at | Fair Value at | Valuation Technique | Unobservable Inputs         | Weighted-Average Discount at |   |
|---|------------|------------------------|---------------|---------------------|-----------------------------|------------------------------|---|
| Asset                                     | 12/31/17   | 12/31/17               | 12/31/17      |                     |                             | 12/31/17                     |   |
| Impaired loans:                           |            |                        |               |                     |                             |                              |   |
| Residential mortgage loans - first liens  | \$ 515     | \$ 122                 | \$ 393        | Sales comparison    | Discount to appraised value | 26                           | % |
| Commercial:                               |            |                        |               |                     |                             |                              |   |

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|  |          |          |          |                  |                             |    |   |
|--|----------|----------|----------|------------------|-----------------------------|----|---|
| Commercial loans secured by real estate        | 2,641    | 919      | 1,722    | Sales comparison | Discount to appraised value | 16 | % |
| Commercial and industrial                      | 126      | 92       | 34       | Sales comparison | Discount to appraised value | 72 | % |
| Loans secured by farmland                      | 494      | 50       | 444      | Sales comparison | Discount to appraised value | 53 | % |
| Total impaired loans                           | \$ 3,776 | \$ 1,183 | \$ 2,593 |                  |                             |    |   |
| Foreclosed assets held for sale - real estate: |          |          |          |                  |                             |    |   |
| Residential (1-4 family)                       | \$ 721   | \$ 0     | \$ 721   | Sales comparison | Discount to appraised value | 37 | % |
| Land   | 632      | 0        | 632      | Sales comparison | Discount to appraised value | 35 | % |
| Commercial real estate                         | 245      | 0        | 245      | Sales comparison | Discount to appraised value | 71 | % |
| Total foreclosed assets held for sale          | \$ 1,598 | \$ 0     | \$ 1,598 |                  |                             |    |   |

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.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

The estimated fair values, and related carrying amounts, of the Corporation's financial instruments that are not recorded at fair value are as follows:

| (In Thousands)  | Fair Value Hierarchy Level | June 30, 2018   |            | December 31, 2017 |            |
|---|----------------------------|-----------------|------------|-------------------|------------|
|   |                            | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets:</b>                                |                            |                 |            |                   |            |
| Cash and cash equivalents                               | Level 1                    | \$48,705        | \$48,705   | \$37,004          | \$37,004   |
| Certificates of deposit                                 | Level 2                    | 2,770           | 2,755      | 3,240             | 3,234      |
| Restricted equity securities (included in Other Assets) | Level 2                    | 5,078           | 5,078      | 6,556             | 6,556      |
| Loans, net  | Level 3                    | 809,816         | 807,330    | 806,857           | 789,891    |
| Accrued interest receivable                             | Level 2                    | 4,042           | 4,042      | 4,048             | 4,048      |
| <b>Financial liabilities:</b>                           |                            |                 |            |                   |            |
| Deposits with no stated maturity                        | Level 2                    | 801,332         | 801,332    | 794,778           | 794,778    |
| Time deposits   | Level 2                    | 239,567         | 239,718    | 213,671           | 213,734    |
| Short-term borrowings                                   | Level 2                    | 17,169          | 16,954     | 61,766            | 61,643     |
| Long-term borrowings                                    | Level 2                    | 27,054          | 27,075     | 9,189             | 9,256      |
| Accrued interest payable                                | Level 2                    | 107             | 107        | 46                | 46         |

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.

**6. SECURITIES**

Amortized cost and fair value of available-for-sale debt securities at June 30, 2018 and December 31, 2017 are summarized as follows:

| (In Thousands)                                    | Amortized Cost | June 30, 2018 |                | Fair Value |
|---|----------------|---------------|----------------|------------|
|   |                | Holding Gains | Holding Losses |            |
| Obligations of U.S. Government agencies           | \$ 7,779       | \$ 0          | \$ 0           | \$ 7,779   |
| Obligations of states and political subdivisions: |                |               |                |            |

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|  |            |          |             |            |
|--|------------|----------|-------------|------------|
| Tax-exempt   | 101,956    | 1,504    | (1,760 )    | 101,700    |
| Taxable  | 26,248     | 60       | (242 )      | 26,066     |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |            |          |             |            |
| Residential pass-through securities  | 60,130     | 59       | (1,859 )    | 58,330     |
| Residential collateralized mortgage obligations  | 126,457    | 22       | (4,546 )    | 121,933    |
| Commercial mortgage-backed securities  | 33,671     | 0        | (1,435 )    | 32,236     |
| Total available-for-sale-debt securities   | \$ 356,241 | \$ 1,645 | \$ (9,842 ) | \$ 348,044 |



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|  |            |             |            |             |            |             |
|--|------------|-------------|------------|-------------|------------|-------------|
| Obligations of U.S. Government agencies  | \$ 0       | \$ 0        | \$ 7,873   | \$ (153 )   | \$ 7,873   | \$ (153 )   |
| Obligations of states and political subdivisions:  |            |             |            |             |            |             |
| Tax-exempt   | 19,050     | (135 )      | 24,391     | (718 )      | 43,441     | (853 )      |
| Taxable  | 9,279      | (45 )       | 2,116      | (39 )       | 11,395     | (84 )       |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |            |             |            |             |            |             |
| Residential pass-through securities  | 25,255     | (242 )      | 22,549     | (482 )      | 47,804     | (724 )      |
| Residential collateralized mortgage obligations  | 50,812     | (589 )      | 68,558     | (2,021 )    | 119,370    | (2,610 )    |
| Commercial mortgage-backed securities  | 14,713     | (173 )      | 14,569     | (493 )      | 29,282     | (666 )      |
| Total temporarily impaired available-for-sale debt securities                                      | \$ 119,109 | \$ (1,184 ) | \$ 140,056 | \$ (3,906 ) | \$ 259,165 | \$ (5,090 ) |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

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

| (In Thousands)                              | 3 Months Ended |               | 6 Months Ended |               |
|---|----------------|---------------|----------------|---------------|
|   | June 30, 2018  | June 30, 2017 | June 30, 2018  | June 30, 2017 |
| Gross realized gains from sales             | \$ 0           | \$ 107        | \$ 0           | \$ 268        |
| Gross realized losses from sales            | 0              | 0             | 0              | (16 )         |
| Losses from other-than-temporary impairment | (282 )         | 0             | (282 )         | 0             |
| Net realized gains                          | \$ (282 )      | \$ 107        | \$ (282 )      | \$ 252        |

The amortized cost and fair value of available-for-sale debt securities by contractual maturity are shown in the following table as of June 30, 2018. 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 Cost | Fair Value |
|--|----------------|------------|
| Due in one year or less  | \$ 19,947      | \$ 20,174  |
| Due from one year through five years   | 61,054         | 61,171     |
| Due from five years through ten years  | 34,534         | 33,663     |
| Due after ten years  | 20,448         | 20,537     |
| Sub-total  | 135,983        | 135,545    |
| Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies: |                |            |
| Residential pass-through securities  | 60,130         | 58,330     |
| Residential collateralized mortgage obligations  | 126,457        | 121,933    |
| Commercial mortgage-backed securities  | 33,671         | 32,236     |
| Total  | \$ 356,241     | \$ 348,044 |

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 \$216,367,000 at June 30, 2018 and \$217,925,000 at December 31, 2017 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.

In the second quarter 2018, the Corporation recorded a pre-tax impairment loss on available-for-sale debt securities of \$282,000. The loss represents the unrealized loss at June 30, 2018 on securities that were sold in July 2018. The securities sold included obligations of U.S. Government agencies and states and political subdivisions. The realized losses on the sales totaled \$329,000, including \$282,000 recorded in the second quarter 2018. Proceeds from the sales totaling \$17,858,000 were reinvested in residential collateralized mortgage obligations.

A summary of information management considered in evaluating debt and equity securities for other-than-temporary impairment ("OTTI") at June 30, 2018 is provided below.



## **CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

### **Debt Securities**

At June 30, 2018, 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 except for the securities for which an impairment loss was recognized in the second quarter 2018 at June 30, 2018 and December 31, 2017 to be temporary.

### **Equity Securities**

The Corporation's marketable equity security, with a carrying value of \$948,000 at June 30, 2018 and \$971,000 at December 31, 2017, consisted exclusively of one mutual fund. There was an unrealized loss on the mutual fund of \$52,000 at June 30 2018 and \$29,000 at December 31, 2017. The increase in the unrealized loss of \$8,000 in the second quarter of 2018 and \$23,000 in the six months ended June 30, 2018 is included in other noninterest income in the consolidated statements of income.

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 \$4,948,000 at June 30, 2018 and \$6,426,000 at December 31, 2017. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at June 30, 2018 and December 31, 2017. 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.

In the second quarter 2018, the Corporation recorded a pre-tax gain on a restricted equity security (Visa Class B stock) of \$1,750,000. The Corporation had received 19,789 shares of Visa Class B stock pursuant to Visa's 2007 initial public offering. Until the second quarter 2018, the carrying value of the shares was \$0, which represented the Corporation's cost basis. Class B shares are subject to restrictions on transfer, essentially limiting their transferability to other owners of Class B shares. In June 2018, the Corporation sold 10,000 of the shares for a price of \$88.43 per share in a transaction that settled in July 2018. As required by "U.S. GAAP", companies must consider the pricing of observable transactions in determining the carrying value of equity securities that do not have readily determinable fair values. Accordingly, the Corporation's second quarter 2018 gain was based on the price per share of the sale initiated in June 2018, applied to the total of 19,789 shares. At June 30, 2018, the balance of other assets in the unaudited, consolidated

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balance sheet included a total of \$1,750,000 from the Visa Class B shares, including a receivable of \$884,000 from the sale of 10,000 shares and \$866,000 from the carrying value of the remaining 9,789 shares.

A summary of the realized and unrealized gains and losses recognized on equity securities is as follows:

(In Thousands)

|   | 3 Months Ended |          | 6 Months Ended |          |
|---|----------------|----------|----------------|----------|
|   | June 30,       | June 30, | June 30,       | June 30, |
|   | 2018           | 2017     | 2018           | 2017     |
| Net gain and losses recognized during the period on equity securities                               | \$ 1,742       | \$ 0     | \$ 1,727       | \$ 0     |
| Less: net gains recognized during the period on equity securities sold during the period            | (884 )         | 0        | (884 )         | 0        |
| Unrealized gains recognized during the period on equity securities still held at the reporting date | \$ 858         | \$ 0     | \$ 843         | \$ 0     |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****7. LOANS**

The loans receivable portfolio is segmented into residential mortgage, commercial and consumer loans. Loans outstanding at June 30, 2018 and December 31, 2017 are summarized by segment, and by classes within each segment, as follows:

| Summary of Loans by Type<br>(In Thousands) | June 30,<br>2018 | Dec. 31,<br>2017 |
|--|------------------|------------------|
| Residential mortgage:                      |                  |                  |
| Residential mortgage loans - first liens   | \$361,592        | \$359,987        |
| Residential mortgage loans - junior liens  | 26,594           | 25,325           |
| Home equity lines of credit                | 34,852           | 35,758           |
| 1-4 Family residential construction        | 26,722           | 26,216           |
| Total residential mortgage                 | 449,760          | 447,286          |
| Commercial:                                |                  |                  |
| Commercial loans secured by real estate    | 159,392          | 159,266          |
| Commercial and industrial                  | 88,499           | 88,276           |
| Political subdivisions                     | 56,690           | 59,287           |
| Commercial construction and land           | 13,066           | 14,527           |
| Loans secured by farmland                  | 7,397            | 7,255            |
| Multi-family (5 or more) residential       | 7,860            | 7,713            |
| Agricultural loans                         | 5,622            | 6,178            |
| Other commercial loans                     | 14,455           | 10,986           |
| Total commercial                           | 352,981          | 353,488          |
| Consumer                                   | 15,906           | 14,939           |
| Total                                      | 818,647          | 815,713          |
| Less: allowance for loan losses            | (8,831 )         | (8,856 )         |
| Loans, net                                 | \$809,816        | \$806,857        |

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 June 30, 2018 or December 31, 2017.

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 June 30, 2018 and December 31, 2017, management determined that no allowance for credit losses related to unfunded loan commitments was required.

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Transactions within the allowance for loan losses, summarized by segment and class, for the three-month and six-month periods ended June 30, 2018 and 2017 were as follows:

| Three Months Ended June 30, 2018<br>(In Thousands) | March 31,<br>2018<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | June 30,<br>2018<br>Balance |
|--|------------------------------|-------------|------------|-----------------------|-----------------------------|
| Allowance for Loan Losses:                         |                              |             |            |                       |                             |
| Residential mortgage:                              |                              |             |            |                       |                             |
| Residential mortgage loans - first liens           | \$ 3,067                     | \$ (34 )    | \$ 1       | \$ 21                 | \$ 3,055                    |
| Residential mortgage loans - junior liens          | 351                          | 0           | 2          | 0                     | 353                         |
| Home equity lines of credit                        | 286                          | (12 )       | 0          | 18                    | 292                         |
| 1-4 Family residential construction                | 239                          | 0           | 0          | 8                     | 247                         |
| Total residential mortgage                         | 3,943                        | (46 )       | 3          | 47                    | 3,947                       |
| Commercial:  |                              |             |            |                       |                             |
| Commercial loans secured by real estate            | 2,635                        | 0           | 0          | (22 )                 | 2,613                       |
| Commercial and industrial                          | 1,036                        | (133 )      | 1          | 69                    | 973                         |
| Commercial construction and land                   | 137                          | 0           | 0          | (2 )                  | 135                         |
| Loans secured by farmland                          | 102                          | 0           | 0          | 4                     | 106                         |
| Multi-family (5 or more) residential               | 169                          | 0           | 0          | 5                     | 174                         |
| Agricultural loans                                 | 205                          | 0           | 0          | (159 )                | 46                          |
| Other commercial loans                             | 149                          | 0           | 0          | (15 )                 | 134                         |
| Total commercial                                   | 4,433                        | (133 )      | 1          | (120 )                | 4,181                       |
| Consumer   | 174                          | (32 )       | 9          | 53                    | 204                         |
| Unallocated  | 499                          | 0           | 0          | 0                     | 499                         |
| Total Allowance for Loan Losses                    | \$ 9,049                     | \$ (211 )   | \$ 13      | \$ (20 )              | \$ 8,831                    |

| Three Months Ended June 30, 2017<br>(In Thousands) | March 31,<br>2017<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | June 30,<br>2017<br>Balance |
|--|------------------------------|-------------|------------|-----------------------|-----------------------------|
| Allowance for Loan Losses:                         |                              |             |            |                       |                             |
| Residential mortgage:                              |                              |             |            |                       |                             |
| Residential mortgage loans - first liens           | \$ 3,125                     | \$ (99 )    | \$ 12      | \$ 14                 | \$ 3,052                    |
| Residential mortgage loans - junior liens          | 256                          | (16 )       | 1          | 20                    | 261                         |
| Home equity lines of credit                        | 338                          | 0           | 0          | (6 )                  | 332                         |
| 1-4 Family residential construction                | 240                          | 0           | 0          | 11                    | 251                         |
| Total residential mortgage                         | 3,959                        | (115 )      | 13         | 39                    | 3,896                       |
| Commercial:  |                              |             |            |                       |                             |
| Commercial loans secured by real estate            | 2,685                        | 0           | 0          | (75 )                 | 2,610                       |
| Commercial and industrial                          | 906                          | (1 )        | 1          | 4                     | 910                         |
| Commercial construction and land                   | 169                          | 0           | 0          | (7 )                  | 162                         |
| Loans secured by farmland                          | 111                          | 0           | 0          | (4 )                  | 107                         |
| Multi-family (5 or more) residential               | 236                          | 0           | 0          | (67 )                 | 169                         |
| Agricultural loans                                 | 39                           | 0           | 0          | 3                     | 42                          |

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|                                 |          |           |       |        |          |
|---------------------------------|----------|-----------|-------|--------|----------|
| Other commercial loans          | 109      | 0         | 0     | (4 )   | 105      |
| Total commercial                | 4,255    | (1 )      | 1     | (150 ) | 4,105    |
| Consumer                        | 132      | (19 )     | 8     | 13     | 134      |
| Unallocated                     | 398      | 0         | 0     | 102    | 500      |
| Total Allowance for Loan Losses | \$ 8,744 | \$ (135 ) | \$ 22 | \$ 4   | \$ 8,635 |

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| Six Months Ended June 30, 2018<br>(In Thousands) | Dec. 31,<br>2017<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | June 30,<br>2018<br>Balance |
|--|-----------------------------|-------------|------------|-----------------------|-----------------------------|
| Allowance for Loan Losses:                       |                             |             |            |                       |                             |
| Residential mortgage:                            |                             |             |            |                       |                             |
| Residential mortgage loans - first liens         | \$ 3,200                    | \$ (87 )    | \$ 2       | \$ (60 )              | \$ 3,055                    |
| Residential mortgage loans - junior liens        | 224                         | 0           | 3          | 126                   | 353                         |
| Home equity lines of credit                      | 296                         | (12 )       | 0          | 8                     | 292                         |
| 1-4 Family residential construction              | 243                         | 0           | 0          | 4                     | 247                         |
| Total residential mortgage                       | 3,963                       | (99 )       | 5          | 78                    | 3,947                       |
| Commercial:                                      |                             |             |            |                       |                             |
| Commercial loans secured by real estate          | 2,584                       | (21 )       | 0          | 50                    | 2,613                       |
| Commercial and industrial                        | 1,065                       | (133 )      | 3          | 38                    | 973                         |
| Commercial construction and land                 | 150                         | 0           | 0          | (15 )                 | 135                         |
| Loans secured by farmland                        | 105                         | 0           | 0          | 1                     | 106                         |
| Multi-family (5 or more) residential             | 172                         | 0           | 0          | 2                     | 174                         |
| Agricultural loans                               | 57                          | 0           | 0          | (11 )                 | 46                          |
| Other commercial loans                           | 102                         | 0           | 0          | 32                    | 134                         |
| Total commercial                                 | 4,235                       | (154 )      | 3          | 97                    | 4,181                       |
| Consumer   | 159                         | (73 )       | 21         | 97                    | 204                         |
| Unallocated                                      | 499                         | 0           | 0          | 0                     | 499                         |
| Total Allowance for Loan Losses                  | \$ 8,856                    | \$ (326 )   | \$ 29      | \$ 272                | \$ 8,831                    |

| Six Months Ended June 30, 2017<br>(In Thousands) | Dec. 31,<br>2016<br>Balance | Charge-offs | Recoveries | Provision (Credit) | June 30,<br>2017<br>Balance |
|--|-----------------------------|-------------|------------|--------------------|-----------------------------|
| Allowance for Loan Losses:                       |                             |             |            |                    |                             |
| Residential mortgage:                            |                             |             |            |                    |                             |
| Residential mortgage loans - first liens         | \$ 3,033                    | \$ (162 )   | \$ 14      | \$ 167             | \$ 3,052                    |
| Residential mortgage loans - junior liens        | 258                         | (16 )       | 2          | 17                 | 261                         |
| Home equity lines of credit                      | 350                         | 0           | 0          | (18 )              | 332                         |
| 1-4 Family residential construction              | 249                         | 0           | 0          | 2                  | 251                         |
| Total residential mortgage                       | 3,890                       | (178 )      | 16         | 168                | 3,896                       |
| Commercial:                                      |                             |             |            |                    |                             |
| Commercial loans secured by real estate          | 2,380                       | (96 )       | 0          | 326                | 2,610                       |
| Commercial and industrial                        | 999                         | (1 )        | 2          | (90 )              | 910                         |
| Commercial construction and land                 | 162                         | 0           | 0          | 0                  | 162                         |
| Loans secured by farmland                        | 110                         | 0           | 0          | (3 )               | 107                         |
| Multi-family (5 or more) residential             | 241                         | 0           | 0          | (72 )              | 169                         |
| Agricultural loans                               | 40                          | 0           | 0          | 2                  | 42                          |
| Other commercial loans                           | 115                         | 0           | 0          | (10 )              | 105                         |
| Total commercial                                 | 4,047                       | (97 )       | 2          | 153                | 4,105                       |
| Consumer   | 138                         | (60 )       | 23         | 33                 | 134                         |
| Unallocated                                      | 398                         | 0           | 0          | 102                | 500                         |
| Total Allowance for Loan Losses                  | \$ 8,473                    | \$ (335 )   | \$ 41      | \$ 456             | \$ 8,635                    |

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.



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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 that follows.

The following tables summarize the aggregate credit quality classification of outstanding loans by risk rating as of June 30, 2018 and December 31, 2017:

June 30, 2018

(In Thousands)

|   | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| <b>Residential Mortgage:</b>              |           |                    |             |          |           |
| Residential mortgage loans - first liens  | \$353,020 | \$ 290             | \$ 8,230    | \$ 52    | \$361,592 |
| Residential mortgage loans - junior liens | 26,051    | 98                 | 445         | 0        | 26,594    |
| Home equity lines of credit               | 34,196    | 60                 | 596         | 0        | 34,852    |
| 1-4 Family residential construction       | 26,722    | 0                  | 0           | 0        | 26,722    |
| Total residential mortgage                | 439,989   | 448                | 9,271       | 52       | 449,760   |
| <b>Commercial:</b>                        |           |                    |             |          |           |
| Commercial loans secured by real estate   | 152,847   | 788                | 5,757       | 0        | 159,392   |
| Commercial and Industrial                 | 82,590    | 4,726              | 1,172       | 11       | 88,499    |
| Political subdivisions                    | 56,690    | 0                  | 0           | 0        | 56,690    |
| Commercial construction and land          | 12,990    | 0                  | 76          | 0        | 13,066    |
| Loans secured by farmland                 | 5,394     | 619                | 1,372       | 12       | 7,397     |
| Multi-family (5 or more) residential      | 7,468     | 0                  | 392         | 0        | 7,860     |
| Agricultural loans                        | 4,858     | 84                 | 680         | 0        | 5,622     |
| Other commercial loans                    | 14,383    | 0                  | 72          | 0        | 14,455    |
| Total commercial                          | 337,220   | 6,217              | 9,521       | 23       | 352,981   |
| Consumer                                  | 15,860    | 0                  | 46          | 0        | 15,906    |
| Totals                                    | \$793,069 | \$ 6,665           | \$ 18,838   | \$ 75    | \$818,647 |

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December 31, 2017

(In Thousands)

|   | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| <b>Residential Mortgage:</b>              |           |                    |             |          |           |
| Residential mortgage loans - first liens  | \$350,609 | \$ 307             | \$ 9,019    | \$ 52    | \$359,987 |
| Residential mortgage loans - junior liens | 24,795    | 104                | 426         | 0        | 25,325    |
| Home equity lines of credit               | 35,233    | 61                 | 464         | 0        | 35,758    |
| 1-4 Family residential construction       | 26,216    | 0                  | 0           | 0        | 26,216    |
| Total residential mortgage                | 436,853   | 472                | 9,909       | 52       | 447,286   |
| <b>Commercial:</b>                        |           |                    |             |          |           |
| Commercial loans secured by real estate   | 150,806   | 936                | 7,524       | 0        | 159,266   |
| Commercial and Industrial                 | 82,724    | 3,896              | 1,645       | 11       | 88,276    |
| Political subdivisions                    | 59,287    | 0                  | 0           | 0        | 59,287    |
| Commercial construction and land          | 14,449    | 0                  | 78          | 0        | 14,527    |
| Loans secured by farmland                 | 5,283     | 581                | 1,379       | 12       | 7,255     |
| Multi-family (5 or more) residential      | 7,130     | 0                  | 583         | 0        | 7,713     |
| Agricultural loans                        | 5,203     | 270                | 705         | 0        | 6,178     |
| Other commercial loans                    | 10,913    | 0                  | 73          | 0        | 10,986    |
| Total commercial                          | 335,795   | 5,683              | 11,987      | 23       | 353,488   |
| Consumer                                  | 14,853    | 0                  | 86          | 0        | 14,939    |
| Totals                                    | \$787,501 | \$ 6,155           | \$ 21,982   | \$ 75    | \$815,713 |

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 a loan: (1) is subject to a restructuring agreement, or (2) has an outstanding balance of \$400,000 or more and a credit grade of Special Mention, Substandard or Doubtful. The pools of loans are evaluated for loss exposure based upon average historical net charge-off rates for each loan class, adjusted for qualitative factors (described in the following paragraphs). The time period used in determining the average historical net charge-off rate for each loan class is based on management's evaluation of an appropriate time period that captures an historical loss experience relevant to the current portfolio. At June 30, 2018 and December 31, 2017, a five-year average net charge-off rate was used for commercial loans secured by real estate and for multi-family residential loans, while a three-year average net charge-off rate was used for all other loan classes.

Qualitative risk factors 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 average net charge-off rate for 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 53% at June 30, 2018) 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.

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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 reviewed individually each quarter to determine if they are impaired include all commercial loan relationships greater than \$200,000 and any residential mortgage or consumer loans of \$400,000 or more for which there is at least one extension of credit graded Special Mention, Substandard or Doubtful. Loans that are individually reviewed, but which are determined to not 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 reviewed, but which have been determined to not be impaired, are included in the "Collectively Evaluated" column in the table summarizing the allowance and associated loan balances as of June 30, 2018 and December 31, 2017. All loans classified as troubled debt restructurings (discussed in more detail below) and all commercial loan relationships less than \$200,000 or other loan relationships less than \$400,000 in the aggregate, but with an estimated loss of \$100,000 or more, are individually evaluated for impairment.

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 June 30, 2018 and December 31, 2017:

| June 30, 2018<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  | \$959                     | \$ 360,633                | \$361,592 | \$0                        | \$ 3,055                  | \$ 3,055 |
| Residential mortgage loans - junior liens | 296                       | 26,298                    | 26,594    | 120                        | 233                       | 353      |
| Home equity lines of credit               | 0                         | 34,852                    | 34,852    | 0                          | 292                       | 292      |
| 1-4 Family residential construction       | 0                         | 26,722                    | 26,722    | 0                          | 247                       | 247      |
| Total residential mortgage                | 1,255                     | 448,505                   | 449,760   | 120                        | 3,827                     | 3,947    |
| <b>Commercial:</b>                        |                           |                           |           |                            |                           |          |
| Commercial loans secured by real estate   | 4,128                     | 155,264                   | 159,392   | 850                        | 1,763                     | 2,613    |
| Commercial and industrial                 | 167                       | 88,332                    | 88,499    | 75                         | 898                       | 973      |
| Political subdivisions                    | 0                         | 56,690                    | 56,690    | 0                          | 0                         | 0        |

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|                                      |         |            |           |          |          |          |
|--------------------------------------|---------|------------|-----------|----------|----------|----------|
| Commercial construction and land     | 0       | 13,066     | 13,066    | 0        | 135      | 135      |
| Loans secured by farmland            | 1,358   | 6,039      | 7,397     | 50       | 56       | 106      |
| Multi-family (5 or more) residential | 392     | 7,468      | 7,860     | 0        | 174      | 174      |
| Agricultural loans                   | 680     | 4,942      | 5,622     | 0        | 46       | 46       |
| Other commercial loans               | 0       | 14,455     | 14,455    | 0        | 134      | 134      |
| Total commercial                     | 6,725   | 346,256    | 352,981   | 975      | 3,206    | 4,181    |
| Consumer                             | 18      | 15,888     | 15,906    | 0        | 204      | 204      |
| Unallocated                          |         |            |           |          |          | 499      |
| Total                                | \$7,998 | \$ 810,649 | \$818,647 | \$ 1,095 | \$ 7,237 | \$ 8,831 |

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| December 31, 2017<br><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  | \$984                     | \$ 359,003                | \$359,987        | \$ 0                       | \$ 3,200                  | \$ 3,200        |
| Residential mortgage loans - junior liens | 302                       | 25,023                    | 25,325           | 122                        | 102                       | 224             |
| Home equity lines of credit               | 0                         | 35,758                    | 35,758           | 0                          | 296                       | 296             |
| 1-4 Family residential construction       | 0                         | 26,216                    | 26,216           | 0                          | 243                       | 243             |
| Total residential mortgage                | 1,286                     | 446,000                   | 447,286          | 122                        | 3,841                     | 3,963           |
| <b>Commercial:</b>                        |                           |                           |                  |                            |                           |                 |
| Commercial loans secured by real estate   | 5,873                     | 153,393                   | 159,266          | 919                        | 1,665                     | 2,584           |
| Commercial and industrial                 | 568                       | 87,708                    | 88,276           | 188                        | 877                       | 1,065           |
| Political subdivisions                    | 0                         | 59,287                    | 59,287           | 0                          | 0                         | 0               |
| Commercial construction and land          | 0                         | 14,527                    | 14,527           | 0                          | 150                       | 150             |
| Loans secured by farmland                 | 1,365                     | 5,890                     | 7,255            | 50                         | 55                        | 105             |
| Multi-family (5 or more) residential      | 392                       | 7,321                     | 7,713            | 0                          | 172                       | 172             |
| Agricultural loans                        | 7                         | 6,171                     | 6,178            | 0                          | 57                        | 57              |
| Other commercial loans                    | 0                         | 10,986                    | 10,986           | 0                          | 102                       | 102             |
| Total commercial                          | 8,205                     | 345,283                   | 353,488          | 1,157                      | 3,078                     | 4,235           |
| Consumer                                  | 20                        | 14,919                    | 14,939           | 0                          | 159                       | 159             |
| Unallocated                               |                           |                           |                  |                            |                           | 499             |
| <b>Total</b>                              | <b>\$9,511</b>            | <b>\$ 806,202</b>         | <b>\$815,713</b> | <b>\$ 1,279</b>            | <b>\$ 7,078</b>           | <b>\$ 8,856</b> |

Summary information related to impaired loans at June 30, 2018 and December 31, 2017 is as follows:

| (In Thousands)                             | June 30, 2018                  |                        |                      | December 31, 2017              |                        |                      |
|--|--------------------------------|------------------------|----------------------|--------------------------------|------------------------|----------------------|
|  | 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   | \$717                          | \$ 688                 | \$ 0                 | \$740                          | \$ 711                 | \$ 0                 |
| Residential mortgage loans - junior liens  | 56                             | 56                     | 0                    | 60                             | 60                     | 0                    |
| Commercial loans secured by real estate    | 1,554                          | 1,554                  | 0                    | 3,230                          | 3,230                  | 0                    |
| Commercial and industrial                  | 92                             | 92                     | 0                    | 119                            | 119                    | 0                    |
| Loans secured by farmland                  | 866                            | 866                    | 0                    | 871                            | 871                    | 0                    |
| Multi-family (5 or more) residential       | 987                            | 392                    | 0                    | 987                            | 392                    | 0                    |
| Agricultural loans                         | 680                            | 680                    | 0                    | 8                              | 8                      | 0                    |
| Consumer                                   | 18                             | 18                     | 0                    | 20                             | 20                     | 0                    |
| Total with no related allowance recorded   | 4,970                          | 4,346                  | 0                    | 6,035                          | 5,411                  | 0                    |
| <b>With a related allowance recorded:</b>  |                                |                        |                      |                                |                        |                      |
| Residential mortgage loans - first liens   | 272                            | 272                    | 0                    | 273                            | 273                    | 0                    |

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|   |         |          |          |          |          |          |
|---|---------|----------|----------|----------|----------|----------|
| Residential mortgage loans - junior liens | 240     | 240      | 120      | 242      | 242      | 122      |
| Commercial loans secured by real estate   | 2,573   | 2,573    | 850      | 2,641    | 2,641    | 919      |
| Commercial and industrial                 | 75      | 75       | 75       | 449      | 449      | 188      |
| Loans secured by farmland                 | 492     | 492      | 50       | 495      | 495      | 50       |
| Total with a related allowance recorded   | 3,652   | 3,652    | 1,095    | 4,100    | 4,100    | 1,279    |
| Total                                     | \$8,622 | \$ 7,998 | \$ 1,095 | \$10,135 | \$ 9,511 | \$ 1,279 |

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In the table immediately above, two loans to one borrower are presented under the Residential mortgage loans – first liens and Residential mortgage loans – junior liens classes. These loans are collateralized by one property, and the allowance associated with these loans was determined based on an analysis of the total amounts of the Corporation’s exposure in comparison to the estimated net proceeds if the Corporation were to sell the property.

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                       |          | 6 Months Ended   |          | 3 Months Ended   |       | 6 Months Ended   |        |
|  | June 30,<br>2018                     | 2017     | June 30,<br>2018 | 2017     | June 30,<br>2018   | 2017  | June 30,<br>2018 | 2017   |
| <b>Residential mortgage:</b>             |                                      |          |                  |          |  |       |                  |        |
| Residential mortgage loans - first lien  | \$ 1,108                             | \$ 738   | \$ 1,077         | \$ 743   | \$ 11  | \$ 8  | \$ 30            | \$ 17  |
| Residential mortgage loans - junior lien | 299                                  | 65       | 300              | 66       | 4  | 1     | 7                | 2      |
| Total residential mortgage               | 1,407                                | 803      | 1,377            | 809      | 15   | 9     | 37               | 19     |
| <b>Commercial:</b>                       |                                      |          |                  |          |  |       |                  |        |
| Commercial loans secured by real estate  | 4,592                                | 6,219    | 5,237            | 6,554    | 35   | 35    | 70               | 91     |
| Commercial and industrial                | 280                                  | 235      | 394              | 241      | 1  | 4     | 7                | 7      |
| Loans secured by farmland                | 1,360                                | 1,382    | 1,362            | 1,386    | 10   | 14    | 16               | 22     |
| Multi-family (5 or more) residential     | 392                                  | 392      | 392              | 392      | 0  | 0     | 0                | 0      |
| Agricultural loans                       | 568                                  | 12       | 457              | 12       | 7  | 0     | 18               | 1      |
| Total commercial                         | 7,192                                | 8,240    | 7,842            | 8,585    | 53   | 53    | 111              | 121    |
| Consumer                                 | 19                                   | 25       | 19               | 29       | 0  | 0     | 0                | 0      |
| Total                                    | \$ 8,618                             | \$ 9,068 | \$ 9,238         | \$ 9,423 | \$ 68  | \$ 62 | \$ 148           | \$ 140 |

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:



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| (In Thousands)                            | June 30, 2018                                 |            | December 31, 2017                             |            |
|---|---|------------|---|------------|
|   | Past<br>Due<br>90+<br>Days<br>and<br>Accruing | Nonaccrual | Past<br>Due<br>90+<br>Days<br>and<br>Accruing | Nonaccrual |
| Residential mortgage:                     |   |            |   |            |
| Residential mortgage loans - first liens  | \$1,848                                       | \$ 4,518   | \$ 2,340                                      | \$ 5,131   |
| Residential mortgage loans - junior liens | 30  | 240        | 105   | 242        |
| Home equity lines of credit               | 98  | 55         | 203   | 44         |
| Total residential mortgage                | 1,976   | 4,813      | 2,648   | 5,417      |
| Commercial:                               |   |            |   |            |
| Commercial loans secured by real estate   | 274   | 3,808      | 175   | 5,645      |
| Commercial and industrial                 | 713   | 167        | 603   | 517        |
| Commercial construction and land          | 0   | 52         | 26  | 52         |
| Loans secured by farmland                 | 212   | 1,304      | 271   | 1,308      |
| Multi-family (5 or more) residential      | 0   | 392        | 0   | 392        |
| Agricultural loans                        | 0   | 680        | 0   | 7          |
| Total commercial                          | 1,199   | 6,403      | 1,075   | 7,921      |
| Consumer                                  | 20  | 14         | 1   | 66         |
| Totals                                    | \$3,195                                       | \$ 11,230  | \$ 3,724                                      | \$ 13,404  |

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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 June 30, 2018 and December 31, 2017:

| (In Thousands)                            | As of June 30, 2018 |                |                |                  | As of December 31, 2017 |                 |                 |                  |
|---|---------------------|----------------|----------------|------------------|-------------------------|-----------------|-----------------|------------------|
|   | Current &           |                |                | Total            | Current &               |                 |                 | Total            |
|   | Past Due            | Past Due       | Past Due       |                  | Past Due                | Past Due        | Past Due        |                  |
|   | Less than 30 Days   | 30-89 Days     | 90+ Days       |                  | Less than 30 Days       | 30-89 Days      | 90+ Days        |                  |
| <b>Residential mortgage:</b>              |                     |                |                |                  |                         |                 |                 |                  |
| Residential mortgage loans - first liens  | \$353,568           | \$4,230        | \$3,794        | \$361,592        | \$347,032               | \$7,967         | \$4,988         | \$359,987        |
| Residential mortgage loans - junior liens | 26,441              | 123            | 30             | 26,594           | 25,133                  | 87              | 105             | 25,325           |
| Home equity lines of credit               | 34,152              | 565            | 135            | 34,852           | 34,789                  | 732             | 237             | 35,758           |
| 1-4 Family residential construction       | 26,722              | 0              | 0              | 26,722           | 25,667                  | 549             | 0               | 26,216           |
| <b>Total residential mortgage</b>         | <b>440,883</b>      | <b>4,918</b>   | <b>3,959</b>   | <b>449,760</b>   | <b>432,621</b>          | <b>9,335</b>    | <b>5,330</b>    | <b>447,286</b>   |
| <b>Commercial:</b>                        |                     |                |                |                  |                         |                 |                 |                  |
| Commercial loans secured by real estate   | 157,813             | 201            | 1,378          | 159,392          | 155,917                 | 311             | 3,038           | 159,266          |
| Commercial and industrial                 | 87,702              | 20             | 777            | 88,499           | 87,306                  | 303             | 667             | 88,276           |
| Political subdivisions                    | 56,690              | 0              | 0              | 56,690           | 59,287                  | 0               | 0               | 59,287           |
| Commercial construction and land          | 12,980              | 34             | 52             | 13,066           | 14,400                  | 49              | 78              | 14,527           |
| Loans secured by farmland                 | 5,884               | 544            | 969            | 7,397            | 6,226                   | 12              | 1,017           | 7,255            |
| Multi-family (5 or more) residential      | 7,446               | 22             | 392            | 7,860            | 7,321                   | 0               | 392             | 7,713            |
| Agricultural loans                        | 5,615               | 1              | 6              | 5,622            | 6,114                   | 57              | 7               | 6,178            |
| Other commercial loans                    | 14,455              | 0              | 0              | 14,455           | 10,986                  | 0               | 0               | 10,986           |
| <b>Total commercial</b>                   | <b>348,585</b>      | <b>822</b>     | <b>3,574</b>   | <b>352,981</b>   | <b>347,557</b>          | <b>732</b>      | <b>5,199</b>    | <b>353,488</b>   |
| Consumer                                  | 15,770              | 112            | 24             | 15,906           | 14,760                  | 123             | 56              | 14,939           |
| <b>Totals</b>                             | <b>\$805,238</b>    | <b>\$5,852</b> | <b>\$7,557</b> | <b>\$818,647</b> | <b>\$794,938</b>        | <b>\$10,190</b> | <b>\$10,585</b> | <b>\$815,713</b> |

Nonaccrual loans are included in the contractual aging in the immediately preceding table. A summary of the contractual aging of nonaccrual loans at June 30, 2018 and December 31, 2017 is as follows:

| (In Thousands)                      | Current &<br>Past Due |                           |                         | Total     |
|-------------------------------------|-----------------------|---------------------------|-------------------------|-----------|
|                                     | Less than<br>30 Days  | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days |           |
| June 30, 2018 Nonaccrual Totals     | \$ 4,937              | \$ 1,931                  | \$ 4,362                | \$ 11,230 |
| December 31, 2017 Nonaccrual Totals | \$ 5,802              | \$ 741                    | \$ 6,861                | \$ 13,404 |

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 June 30, 2018 and December 31, 2017 is as follows:

| (In Thousands)           | Current &<br>Past Due |                           |                         | Nonaccrual | Total    |
|--------------------------|-----------------------|---------------------------|-------------------------|------------|----------|
|                          | Less than<br>30 Days  | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days |            |          |
| June 30, 2018 Totals     | \$ 651                | \$ 102                    | \$ 0                    | \$ 2,951   | \$ 3,704 |
| December 31, 2017 Totals | \$ 636                | \$ 0                      | \$ 0                    | \$ 3,027   | \$ 3,663 |

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At June 30, 2018 and December 31, 2017, there were no commitments to loan additional funds to borrowers whose loans have been classified as TDRs.

There were no TDRs that occurred during the three-month periods ended June 30, 2018 and 2017. TDRs that occurred during the six-month periods ended June 30, 2018 and 2017 are as follows:

| (Balances in Thousands)  | Six Months Ended<br>June 30, 2018 |   | Six Months Ended<br>June 30, 2017 |   |
|--|-----------------------------------|---|-----------------------------------|---|
|  | Number<br>of<br>Loans             | Post-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans             | Post-<br>Modification<br>Recorded<br>Investment |
| Residential mortgage - first liens,<br>Reduced monthly payments for a six-month period             | 1                                 | \$ 80   | 0                                 | \$ 0  |
| Commercial loans secured by real estate,<br>Extended interest only payments for a six-month period | 2                                 | 36  | 0                                 | 0   |
| Commercial and industrial,<br>Extended interest only payments for a six-month period               | 1                                 | 46  | 0                                 | 0   |
| Total  | 4                                 | \$ 162  | 0                                 | \$ 0  |

In the six-month periods ended June 30, 2018 and 2017, there were no defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months.

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 sheets) is as follows:

| (In Thousands)                     | June 30,<br>2018 | Dec. 31,<br>2017 |
|------------------------------------|------------------|------------------|
| Foreclosed residential real estate | \$ 412           | \$ 721           |

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) | June 30,<br>2018 | Dec. 31,<br>2017 |
|----------------|------------------|------------------|
|----------------|------------------|------------------|

Residential real estate in process of foreclosure \$ 1,150 \$ 1,789

## 8. BORROWED FUNDS

Short-term borrowings (initial maturity within one year) include the following:

| (In Thousands)                 | June 30,<br>2018 | Dec. 31,<br>2017 |
|--------------------------------|------------------|------------------|
| FHLB-Pittsburgh borrowings     | \$12,000         | \$58,000         |
| Customer repurchase agreements | 5,169            | 3,766            |
| Total short-term borrowings    | \$17,169         | \$61,766         |

The FHLB-Pittsburgh loan facilities are collateralized by qualifying loans secured by real estate with a book value totaling \$493,749,000 at June 30, 2018 and \$488,889,000 at December 31, 2017. 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 \$4,948,000 at June 30, 2018 and \$6,426,000 at December 31, 2017.

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At June 30, 2018, the short-term borrowings from FHLB-Pittsburgh consisted of 4 advances of \$3,000,000 each maturing monthly from July to October 2018, with a weighted average interest rate of 1.85%. At December 31, 2017, the short-term borrowings from FHLB-Pittsburgh of \$58,000,000 included an overnight borrowing of \$29,000,000 with an interest rate of 1.54% and other short-term advances totaling \$29,000,000 with a weighted average rate of 1.69%.

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 June 30, 2018 and December 31, 2017. The carrying value of the underlying securities was \$10,770,000 at June 30, 2018 and \$12,158,000 at December 31, 2017.

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

| (In Thousands)                                      | June 30,<br>2018 | Dec. 31,<br>2017 |
|---|------------------|------------------|
| Loan maturing in November 2018 with a rate of 1.63% | \$3,000          | \$ 3,000         |
| Loan maturing in December 2018 with a rate of 1.35% | 3,000            | 3,000            |
| Loan maturing in January 2019 with a rate of 1.83%  | 2,000            | 2,000            |
| Loan maturing in February 2019 with a rate of 1.95% | 3,000            | 0                |
| Loan maturing in March 2019 with a rate of 2.15%    | 3,000            | 0                |
| Loan maturing in April 2019 with a rate of 2.24%    | 3,000            | 0                |
| Loan maturing in May 2019 with a rate of 2.30%      | 3,000            | 0                |
| Loan maturing in June 2019 with a rate of 2.42%     | 3,000            | 0                |
| Loan maturing in July 2019 with a rate of 2.41%     | 3,000            | 0                |
| Loan maturing in April 2020 with a rate of 4.79%    | 368              | 463              |
| Loan maturing in June 2025 with a rate of 4.91%     | 686              | 726              |
| Total long-term FHLB-Pittsburgh borrowings          | \$27,054         | \$ 9,189         |

**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. The 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 June 30, 2018 and December 31, 2017, 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               |       |
|---|------------------------------|-------|------------------------------|-------|
|   | Six Months Ended<br>June 30, |       | Six Months Ended<br>June 30, |       |
|   | 2018                         | 2017  | 2018                         | 2017  |
| Service cost                            | \$ 0                         | \$ 0  | \$ 20                        | \$ 18 |
| Interest cost                           | 13                           | 12    | 26                           | 28    |
| Expected return on plan assets          | (10 )                        | (15 ) | 0                            | 0     |
| Amortization of prior service cost      | 0                            | 0     | (16 )                        | (15 ) |
| Recognized net actuarial loss           | 6                            | 3     | 0                            | 0     |
| Net periodic benefit cost               | \$ 9                         | \$ 0  | \$ 30                        | \$ 31 |

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## Defined Benefit Plans

(In Thousands)

|                                    | Pension            |      | Postretirement     |       |
|------------------------------------|--------------------|------|--------------------|-------|
|                                    | Three Months Ended |      | Three Months Ended |       |
|                                    | June 30,           |      | June 30,           |       |
|                                    | 2018               | 2017 | 2018               | 2017  |
| Service cost                       | \$ 0               | \$ 0 | \$ 10              | \$ 9  |
| Interest cost                      | 7                  | 6    | 13                 | 14    |
| Expected return on plan assets     | (5 )               | (7 ) | 0                  | 0     |
| Amortization of prior service cost | 0                  | 0    | (8 )               | (7 )  |
| Recognized net actuarial loss      | 3                  | 1    | 0                  | 0     |
| Net periodic benefit cost          | \$ 5               | \$ 0 | \$ 15              | \$ 16 |

Service cost, interest cost and expected return on plan assets are included in pensions and other employee benefits expense in the consolidated statements of income in the first six months 2018 and 2017. Amortization of prior service cost and the recognized net actuarial loss are included in other noninterest expense in the consolidated statements of income in the first six months 2018 and 2017.

In the first six months of 2018, the Corporation funded postretirement contributions totaling \$24,000, with estimated annual postretirement contributions of \$60,000 expected in 2018 for the full year. No defined benefit pension contributions are required in 2018, 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 first quarter 2018, the Corporation awarded 25,466 shares of restricted stock under the Stock Incentive Plan and 9,086 shares of restricted stock under the Independent Directors Stock Incentive Plan. The 2018 restricted stock awards under the Stock Incentive Plan vest ratably over three years, and vesting for one-half of the 16,578 restricted shares awarded to Executive Officers depends on the Corporation meeting a return on average equity (“ROAE”) target each year. The 2018 restricted stock issued under the Independent Directors Stock Incentive Plan vests over one year.

Compensation cost related to restricted stock is recognized based on the fair value of the stock at the grant date over the vesting period, adjusted for estimated and actual forfeitures. Management has estimated restricted stock expense in the first six months of 2018 based on an assumption that the ROAE target for awards to Executive Officers in 2016, 2017 and 2018 will not be met, resulting in forfeiture of the restricted stock.



Total annual stock-based compensation for the year ending December 31, 2018 is estimated to total \$714,000. If the ROAE targets for awards to Executive Officers in 2016, 2017 and 2018 are met or exceeded, total annual stock-based compensation would increase by approximately \$190,000. Total stock-based compensation expense attributable to restricted stock awards amounted to \$155,000 in the second quarter 2018 and \$338,000 in the six-month period ended June 30, 2018. Total stock-based compensation expense attributable to restricted stock awards amounted to \$154,000 in the second quarter 2017 and \$322,000 in the six-month period ended June 30, 2017.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****11. INCOME TAXES**

The net deferred tax asset at June 30, 2018 and December 31, 2017 represents the following temporary difference components:

| (In Thousands)  | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
| Deferred tax assets:  |                  |                      |
| Unrealized holding losses on available-for-sale securities: |                  |                      |
| Included in accumulated other comprehensive loss            | \$ 1,721         | \$ 843               |
| Included in retained earnings                               | 0                | (337 )               |
| Allowance for loan losses                                   | 1,889            | 1,894                |
| Other deferred tax assets                                   | 1,813            | 1,726                |
| Total deferred tax assets                                   | 5,423            | 4,126                |
| Deferred tax liabilities:                                   |                  |                      |
| Defined benefit plans - ASC 835:                            |                  |                      |
| Included in accumulated other comprehensive loss            | 36               | 31                   |
| Included in retained earnings                               | 0                | (12 )                |
| Bank premises and equipment                                 | 834              | 751                  |
| Core deposit intangibles                                    | 2                | 3                    |
| Other deferred tax liabilities                              | 247              | 64                   |
| Total deferred tax liabilities                              | 1,119            | 837                  |
| Deferred tax asset, net                                     | \$ 4,304         | \$ 3,289             |

In December 2017, the Corporation recognized an adjustment in the carrying value of the net deferred tax asset as a result of a reduction in the federal corporate income tax rate to 21%, effective January 1, 2018, from the 35% marginal rate that had previously been in effect. At December 31, 2017, the portion of the adjustment attributable to items of accumulated other comprehensive income (loss) were stranded in retained earnings, including components related to unrealized losses on securities and defined benefit plans. As described in Note 1, the Corporation elected early adoption of ASU 2018-02, resulting in a reclassification between two categories of stockholders' equity at January 1, 2018, with an increase of \$325,000 in retained earnings and a decrease in accumulated other comprehensive loss for the same amount. Management believes the Corporation's accounting for the effects of the reduction in the federal income tax rate is materially complete at June 30, 2018.

The provision for income tax for the three-month and six-month periods ended June 30, 2018 and 2017 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:

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| (Dollars In thousands)             | Three Months Ended |          | Six Months Ended |         |
|------------------------------------|--------------------|----------|------------------|---------|
|                                    | June 30,<br>2018   | 2017     | June 30,<br>2018 | 2017    |
| Income before income tax provision | \$ 7,748           | \$ 5,495 | \$12,864         | \$9,913 |
| Income tax provision               | 1,377              | 1,374    | 2,118            | 2,358   |
| Effective tax rate                 | 17.77 %            | 25.00 %  | 16.46 %          | 23.79 % |

The effective tax rate for each period presented differs from the statutory rate of 21% for the period ended June 30, 2018 and 35% for the period ended June 30, 2017 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 through 2017 and expects to continue to receive tax credits annually through 2022. The carrying amount of the Corporation's investment is \$553,000 at June 30, 2018 and \$608,000 at December 31, 2017 (included in Other Assets in the consolidated balance sheets). For the year ending December 31, 2018, the estimated amount of tax credits and other tax benefits to be received is \$150,000 and the estimated amount to be recognized as a reduction of the provision for income taxes is \$54,000. The total reduction in the provision for income taxes resulting from this investment is \$13,000 in the second quarter 2018 and \$27,000 for the six months ended June 30, 2018, and \$19,000 in the second quarter 2016 and \$37,000 for the six months ended June 30, 2017.

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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 2014.

### **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. REVENUE RECOGNITION**

As disclosed in Note 1, as of January 1, 2018, the Corporation adopted ASU 2014-09, Revenue from Contracts with Customers (Topic 606), as well as subsequent ASUs that modified ASC 606. The Company has elected to apply the ASU and all related ASUs using the modified retrospective implementation method. The implementation of the guidance had no material impact on the measurement or recognition of revenue of prior periods. The Corporation generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Additional disclosures related to the Corporation's largest sources of noninterest income within the consolidated statements of income that are subject to ASC 606 are as follows:

**Trust and financial management revenue** – C&N Bank's trust division provides a wide range of financial services, including wealth management services for individuals, businesses and retirement funds, administration of 401(k) and other retirement plans, retirement planning, estate planning and estate settlement services. Trust clients are located primarily within the Corporation's geographic markets. Assets held in a fiduciary capacity by C&N Bank are not the Corporation's assets and are therefore not included in the consolidated balance sheets. The fair value of trust assets under management was approximately \$927,089,000 at June 30, 2018 and \$916,580,000 at December 31, 2017. Trust and financial management revenue is included within noninterest income in the consolidated statements of income.

Trust revenue is recorded on a cash basis, which is not materially different from the accrual basis. The majority (approximately 81%, based on annual 2017 results) of trust revenue is earned and collected monthly, with the amount determined based on a percentage of the fair value of the trust assets under management. Wealth management fees are contractually agreed with each customer, and fee levels vary based mainly on the size of assets under management. The services provided under such a contract represent a single performance obligation under the ASU because it embodies a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. None of the contracts with trust customers provide for incentive-based fees. In addition to wealth management fees, trust revenue includes fees for provision of services, including employee benefit plan administration, tax return preparation and estate planning and settlement. Fees for such services are billed based on contractual arrangements or established fee schedules, and are typically billed upon completion of providing such services. The costs of acquiring trust customers are incremental and recognized within noninterest expense in the consolidated statements of income.

**Service charges on deposit accounts** - Deposits are included as liabilities in the consolidated balance sheets. Service charges on deposit accounts include: overdraft fees, which are charged when customers overdraw their accounts beyond available funds; automated teller machine (ATM) fees charged for withdrawals by deposit customers from other financial institutions' ATMs; and a variety of other monthly or transactional fees for services provided to retail and business customers, mainly associated with checking accounts. All deposit liabilities are considered to have one-day terms and therefore related fees are recognized in income at the time when the services are provided to the customers. Incremental costs of obtaining deposit contracts are not significant and are recognized as expense when incurred within noninterest expense in the consolidated statements of income.

**Interchange revenue from debit card transactions** – The Corporation issues debit cards to consumer and business customers with checking, savings or money market deposit accounts. Debit card and ATM transactions are processed via electronic systems that involve several parties. The Corporation's debit card and ATM transaction processing is executed via contractual arrangements with payment processing networks, a processor and a settlement bank. As described above, all deposit liabilities are considered to have one-day terms and therefore interchange revenue from customers' use of their debit cards to initiate transactions are recognized in income at the time when the services are provided and related fees received in the Corporation's deposit account with the settlement bank. Incremental costs associated with ATM and interchange processing are recognized as expense when incurred within noninterest expense in the consolidated statements of income.

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**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**

Net income was \$0.52 per diluted share in the second quarter 2018, up from \$0.36 in the first quarter 2018 and \$0.34 in the second quarter 2017. Second quarter 2018 earnings included a net benefit of \$0.10 per diluted share from a gain on a restricted equity security (Visa Inc. Class B stock) and a loss on available-for-sale debt securities. For the six months ended June 30, 2018, net income was \$0.87 per diluted share, including a net benefit of \$0.09 per diluted share from the gain on Visa Class B stock and the loss on available-for-sale debt securities. In comparison, net income was \$0.62 per diluted share for the six months ended June 30, 2017, including a benefit of \$0.01 per diluted share from a gain on available-for-sale debt securities.

In the second quarter 2018, the Corporation recorded a pre-tax gain on Visa Class B stock of \$1,750,000. The Corporation had received 19,789 shares of Visa Class B stock pursuant to Visa's 2007 initial public offering. Until the second quarter 2018, the carrying value of the shares was \$0, which represented the Corporation's cost basis. Class B shares are subject to restrictions on transfer, essentially limiting their transferability to other owners of Class B shares. In June 2018, the Corporation received an offer and agreed to sell 10,000 of the shares for a price of \$88.43 per share. This transaction settled in July 2018. Under current accounting guidance, public companies must consider the pricing of observable transactions in determining the carrying value of equity securities that do not have readily determinable fair values. Accordingly, the total second quarter 2018 gains (realized and unrealized) was based on the price per share of the recent sale, applied to the total of 19,789 shares.

At June 30, 2018, the Corporation recorded a pre-tax impairment loss on available-for-sale debt securities of \$282,000. The loss represents the unrealized loss at June 30, 2018 on securities that were sold in July 2018. The securities sold included obligations of U.S. Government agencies and states and political subdivisions. The realized losses on the sales totaled \$329,000, including \$282,000 recorded in the second quarter 2018. Proceeds from the sales totaling \$17.8 million were reinvested in fixed rate mortgage-backed securities issued by U.S. Government agencies (CMOs). The recent fully taxable equivalent yield on the securities sold was 1.73%, while the estimated average yield on the CMOs purchased (at current market rates) is 3.36%.

The table below provides a reconciliation of second quarter and June 30, 2018 year-to-date unaudited earnings results to the comparative 2017 results excluding the gain on Visa Class B stock and gains and losses on available-for-sale debt securities.

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(Dollars In Thousands, Except Per Share Data)

(Unaudited)

|   | 2nd Quarter 2018                   |                          |            | Diluted Earnings per Common Share | 2nd Quarter 2017                      |                      |            | Diluted Earnings per Common Share |
|---|------------------------------------|--------------------------|------------|-----------------------------------|---------------------------------------|----------------------|------------|-----------------------------------|
|   | Income Before Income Tax Provision | Income Tax Provision (1) | Net Income |                                   | Income Before Income Tax Provision(1) | Income Tax Provision | Net Income |                                   |
| Results as Presented Under U.S. GAAP  | \$7,748                            | \$ 1,377                 | \$6,371    | \$ 0.52                           | \$5,495                               | \$ 1,374             | \$4,121    | \$ 0.34                           |
| Less: Gain on Restricted Equity Security  | (1,750)                            | (368 )                   | (1,382)    |                                   | 0                                     | 0                    | 0          |                                   |
| Net Losses (Gains) on Available-for-sale Debt Securities  | 282                                | 59                       | 223        |                                   | (107 )                                | (37 )                | (70 )      |                                   |
| Earnings Information, Excluding Effect of Gain on Restricted Equity Security and Net Gains and Losses on Available-for-sale Debt Securities | \$6,280                            | \$ 1,068                 | \$5,212    | \$ 0.42                           | \$5,388                               | \$ 1,337             | \$4,051    | \$ 0.33                           |

|   | 6 Months Ended June 30, 2018       |                          |            | Diluted Earnings per Common Share | 6 Months Ended June 30, 2017          |                      |            | Diluted Earnings per Common Share |
|---|------------------------------------|--------------------------|------------|-----------------------------------|---------------------------------------|----------------------|------------|-----------------------------------|
|   | Income Before Income Tax Provision | Income Tax Provision (1) | Net Income |                                   | Income Before Income Tax Provision(1) | Income Tax Provision | Net Income |                                   |
| Results as Presented Under U.S. GAAP  | \$12,864                           | \$ 2,118                 | \$10,746   | \$ 0.87                           | \$9,913                               | \$ 2,358             | \$7,555    | \$ 0.62                           |
| Less: Gain on Restricted Equity Security  | (1,750 )                           | (368 )                   | (1,382 )   |                                   | 0                                     | 0                    | 0          |                                   |
| Net Losses (Gains) on Available-for-sale Debt Securities  | 282                                | 59                       | 223        |                                   | (252 )                                | (88 )                | (164 )     |                                   |
| Earnings Information, Excluding Effect of Gain on Restricted Equity Security and Net Gains and Losses on Available-for-sale Debt Securities | \$11,396                           | \$ 1,809                 | \$9,587    | \$ 0.78                           | \$9,661                               | \$ 2,270             | \$7,391    | \$ 0.61                           |

(1) Income tax has been allocated to the gain on restricted equity security and net losses (gains) on available-for-sale debt securities based on marginal income tax rates of 21% for 2018 and 35% for 2017.

Additional highlights related to the Corporation's earnings results for the comparative periods are presented below.

**Second Quarter 2018 as Compared to Second Quarter 2017**



Net income of \$6,371,000 in the second quarter 2018 was up \$2,250,000 over the second quarter 2017 amount. Excluding the after-tax impact of the gain on Visa Class B stock and net (losses) gains on available-for-sale debt securities as described above, adjusted second quarter 2018 net income of \$5,212,000 exceeded adjusted second quarter 2017 net income of \$4,051,000 by \$1,161,000 (28.7%). The marginal federal income tax rate in effect in 2018 is 21%, down from the 2017 marginal rate of 35%. Accordingly, the effective tax rate of 17.8% for the second quarter 2018 was significantly lower than the second quarter 2017 effective tax rate of 25.0%. Pre-tax income, excluding the gain on Visa Class B stock and net (losses) gains on available-for-sale debt securities, totaled \$6,280,000 in the second quarter 2018, an increase of \$892,000 (16.6%) over adjusted pre-tax income of \$5,388,000 in the second quarter 2017. Other significant earnings-related variances were as follows:

Net interest income increased \$893,000 (8.6%) in the second quarter 2018 over the second quarter 2017 amount. Total interest and dividend income increased \$994,000, while interest expense increased \$101,000. The net interest margin of 3.87% for the second quarter 2018 was 0.04% higher than the second quarter 2017 level. Despite the decrease in fully taxable-equivalent yields on municipal securities and loans resulting from the reduced corporate tax rate, the average yield on earning assets increased to 4.23% in the second quarter 2018 from 4.17% in the second quarter 2017. The improvement in average yield included the impact of an increase in average yield on taxable loans, reflecting the effects of recent increases in interest rates, along with a favorable change in the mix of earning assets with growth in loans and a reduction in securities. Average total loans outstanding were higher by \$54.1 million (7.0%) in the second quarter 2018 as compared to the second quarter 2017, while average total available-for-sale debt securities were lower by \$19.2 million. Average total deposits were \$48.6 million (5.0%) higher in the second quarter 2018 as compared to the second quarter 2017. In the second quarter 2018, average brokered deposits (CDs) totaled \$1,813,000, while there were no brokered deposits in the second quarter 2017. The average rate paid on interest-bearing liabilities was 0.52% in the second quarter 2018, up 0.04% as compared to the second quarter 2017. The average rate paid on deposits was up 0.14% in the second quarter 2018 as compared to the second quarter 2017, while the average cost of borrowed funds dropped to 1.75% from 2.71% as a result of the pay-off of higher-cost borrowings that matured in the latter portion of 2017.

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The credit for loan losses (reduction in expense) was \$20,000 in the second quarter 2018 as compared to a provision of \$4,000 in the second quarter 2017. As noted above, the credit recognized in the second quarter 2018 included a credit of \$78,000 from a net reduction in specific allowances on loans, as adjusted for net charge-offs during the period, partially offset by a provision of \$58,000 attributable mainly to loan growth. In comparison, the second quarter 2017 provision included \$315,000 related to the change in total specific allowances on impaired loans, as adjusted for net charge-offs during the period and a \$102,000 increase in the unallocated portion of the allowance, offset by a \$413,000 reduction in the collectively determined portion of the allowance at June 30, 2017.

Noninterest income increased \$583,000 (14.2%) in the second quarter 2018 over the second quarter 2017 amount. Service charges on deposit accounts increased \$190,000 (17.1%) in the second quarter 2018 over the second quarter 2017 total, mainly due to increased fees from the overdraft privilege program and reflecting the benefit of operational improvements to the program that were instituted early in 2018. Other noninterest income increased \$262,000 in the second quarter 2018 as compared to the second quarter 2017, including an increase of \$154,000 in state tax credits related to donation of the real estate used at the Towanda, Pennsylvania banking location (described in more detail below).

Total noninterest expense increased \$608,000 (6.7%) in the second quarter 2018 over the second quarter 2017 amount. Salaries and wages expense increased \$221,000 (5.6%), including the effects of annual performance-based salary adjustments for a majority of employees along with an increase of \$73,000 in estimated cash and stock-based compensation expense and an increase in the average number of full-time equivalent employees (FTEs) to 297 in the second quarter 2018 from 292 in the second quarter 2017. Other noninterest expense increased \$122,000, including an increase in donations expense of \$226,000 resulting mainly from the donation of the Towanda real estate to a nonprofit organization. In June 2018, the Corporation donated the real estate for its existing Towanda banking facility, and entered into a 12-month lease with the nonprofit organization, with a 6-month renewal option, allowing banking operations to continue until a new location in the Towanda market can be obtained and prepared for use. Also, in the second quarter 2018, the Corporation received refunds of sales and use taxes totaling \$37,000, which were recorded as a reduction in other noninterest expense; in comparison, sales and use tax audit assessments totaling \$65,000 were paid and recognized as other noninterest expense in the second quarter 2017. Over the last half of 2017 and early 2018, the Corporation installed a new telephone system throughout most locations and implemented a new loan origination system. Costs associated with these projects contributed to increases in professional fees, data processing and other noninterest expense in the second quarter 2018 as compared to the second quarter 2017.

**Six Months Ended June 30, 2018 as Compared to Six Months Ended June 30, 2017**

For the six months ended June 30, 2018, net income of \$10,746,000 exceeded the corresponding amount for the first six months of 2017 by \$3,191,000. Excluding the after-tax impact of the gain on Visa Class B stock and net (losses) gains on available-for-sale debt securities as described above, adjusted year-to-date 2018 net income of \$9,587,000 exceeded adjusted net income for the first six months of 2017 of \$7,391,000 by \$2,196,000 (29.7%). As a result of the lower marginal federal income tax rate in effect in 2018, the effective tax rate was 16.5% for the first six months of 2018, down from 23.8% for the first six months of 2017. Pre-tax income, excluding the gain on Visa Class B stock and net (losses) gains on available-for-sale debt securities, totaled \$11,396,000 for the first six months of 2018, an

increase of \$1,735,000 (18.0%) over adjusted pre-tax income of \$9,661,000 for the first six months of 2017. Other significant earnings-related variances were as follows:

Net interest income was up \$1,631,000 (8.0%) for the first six months of 2018 over the amount for the first six months of 2017. Trends for the first six months of 2018 as compared to the first six months of 2017 were similar to those described in the comparison of quarterly results above. The net interest margin was 3.86% for the first six months of 2018, up from 3.81% for the first six months of 2017. The average yield on earning assets was 4.21% in the first six months of 2018, up from 4.14% in the first six months of 2017, reflecting an increase in average yield on loans of 0.10% and a favorable change in the mix of earning assets with growth in loans and a reduction in securities. Average total loans outstanding were higher by \$55.8 million (7.3%) for the first six months of 2018 as compared to the first six months of 2017, while average total available-for-sale debt securities were lower by \$27.0 million. Average total deposits were \$39.5 million (4.0%) higher for the first six months of 2018 as compared to 2017. In the first six months of 2018, average brokered deposits (CDs) totaled \$912,000, while there were no brokered deposits in the first six months of 2017. The average rate paid on interest-bearing liabilities was 0.51% in the first six months of 2018, up 0.03% as compared to 2017. The average rate paid on deposits was up 0.12% in the first six months of 2018 as compared to 2017, while the average cost of borrowed funds dropped to 1.69% from 2.42% as a result of the pay-off of higher-cost borrowings that matured in the latter portion of 2017.

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The provision for loan losses was \$272,000 for the first six months of 2018 as compared to \$456,000 in 2017. The provision in 2018 included \$113,000 from a net increase in specific allowances on loans, as adjusted for net charge-offs during the period, and \$159,000 attributable mainly to loan growth. In comparison, the provision in 2017 included \$703,000 related to the change in total specific allowances on impaired loans, as adjusted for net charge-offs during the period and a \$102,000 increase in the unallocated portion of the allowance, with a reduction in the provision of \$349,000 related to a reduction in the collectively determined allowance for loan losses.

Noninterest income, excluding the gain on Visa Class B stock and net (losses) gains on available-for-sale debt securities, increased \$1,125,000 (14.1%) for the first six months of 2018 over the amount for the first six months of 2017. Service charges on deposit accounts increased \$293,000 (13.2%), mainly due to increased fees from the overdraft privilege program and reflecting the benefit of operational improvements to the program that were instituted early in 2018. Trust and financial management revenue increased \$271,000 (10.1%), reflecting growth in assets under management resulting from market appreciation and new business. Other noninterest income increased \$254,000, including an increase in tax credits of \$131,000 resulting from the state tax credit related to the real estate donation described above. Interchange revenue from debit card transactions and brokerage revenue also increased by significant amounts, reflecting increases in volume.

Total noninterest expense increased \$1,205,000 (6.6%) for the first six months of 2018 over the amount for the first six months of 2017. Salaries and wages expense increased \$477,000 (6.1%), including the effects of annual performance-based salary adjustments for a majority of employees along with an increase of \$159,000 in estimated cash and stock-based compensation expense and an increase in the average number of full-time equivalent employees (FTEs) to 295 in 2018 from 290 in 2017. Pensions and other employee benefits expense increased \$149,000 (5.6%), consistent with the increase in salaries and wages and including an increase of \$113,000 (12.5%) in health insurance expense from the Corporation's partially self-insured plan. As noted above, costs associated with new telephone and loan origination systems contributed to increases in professional fees, data processing and other noninterest expense in 2018.

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  
(Dollars In Thousands, Except Per Share Data)

| (Unaudited)  | For the Three Months Ended: |                      |                  |                   |                  |                      |
|--|-----------------------------|----------------------|------------------|-------------------|------------------|----------------------|
|  | June 30,<br>2018            | March<br>31,<br>2018 | Dec. 31,<br>2017 | Sept. 30,<br>2017 | June 30,<br>2017 | March<br>31,<br>2017 |
| Interest income  | \$12,334                    | \$11,890             | \$11,785         | \$11,626          | \$11,340         | \$11,112             |
| Interest expense   | 1,079                       | 993                  | 999              | 985               | 978              | 953                  |
| Net interest income  | 11,255                      | 10,897               | 10,786           | 10,641            | 10,362           | 10,159               |
| (Credit) provision for loan losses                           | (20 )                       | 292                  | 23               | 322               | 4                | 452                  |
| Net interest income after (credit) provision for loan losses | 11,275                      | 10,605               | 10,763           | 10,319            | 10,358           | 9,707                |
| Noninterest income   | 4,689                       | 4,406                | 4,117            | 4,066             | 4,106            | 3,864                |

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|  |         |         |         |         |         |         |
|--|---------|---------|---------|---------|---------|---------|
| Net gains on securities                  | 1,468   | 0       | 0       | 5       | 107     | 145     |
| Noninterest expense                      | 9,684   | 9,895   | 9,401   | 9,192   | 9,076   | 9,298   |
| Income before income tax provision       | 7,748   | 5,116   | 5,479   | 5,198   | 5,495   | 4,418   |
| Income tax provision                     | 1,377   | 741     | 3,536   | 1,262   | 1,374   | 984     |
| Net income                               | \$6,371 | \$4,375 | \$1,943 | \$3,936 | \$4,121 | \$3,434 |
| Net income attributable to common shares | \$6,339 | \$4,352 | \$1,933 | \$3,916 | \$4,100 | \$3,416 |
| Basic earnings per common share          | \$0.52  | \$0.36  | \$0.16  | \$0.32  | \$0.34  | \$0.28  |
| Diluted earnings per common share        | \$0.52  | \$0.36  | \$0.16  | \$0.32  | \$0.34  | \$0.28  |

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### **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 six-month periods ended June 30, 2018 and 2017. 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.

### **Six-Month Periods Ended June 30, 2018 and 2017**

For the six-month periods, fully taxable equivalent net interest income was \$22,812,000 in 2018, \$909,000 (4.2%) higher than in 2017. Interest income was \$1,050,000 higher in 2018 as compared to 2017, while interest expense was higher by \$141,000 in comparing the same periods. As presented in Table III, the Net Interest Margin was 3.86% in 2018 as compared to 3.81% in 2017, and the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.70% in 2018, up from 3.66% in 2017.

### **INTEREST INCOME AND EARNING ASSETS**

Interest income totaled \$24,884,000 in 2018, an increase of 4.4% from 2017. Interest and fees on loans receivable increased \$1,747,000, or 9.5%, to \$20,182,000 in 2018 from \$18,435,000 in 2017. Table IV shows the increase in interest on loans includes \$1,332,000 attributable to an increase in volume and \$415,000 related to an increase in average rate. The average balance of loans receivable increased \$55,817,000 (7.3%) to \$821,225,000 in 2018 from \$765,408,000 in 2017. The increase in average balance reflects the Corporation's significant growth in both commercial and residential mortgage loans in 2017. The average rate on taxable loans in 2018 was 5.09% compared to 4.89% in 2017 as current rates on variable rate loans and rates on recent new loan originations have increased, consistent with increases in market interest rates. The yield on tax-exempt loans receivable decreased to 3.69% in 2018 compared to 4.51% in 2017. This decrease reflects the reduced tax benefit on tax-exempt assets as compared to taxable assets resulting from the marginal tax rate being reduced to 21% in 2018 from 35% in 2017.

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Interest income on available-for-sale debt securities totaled \$4,539,000 in 2018, a reduction of \$767,000 from the total for 2017. As indicated in Table III, average available-for-sale debt securities (at amortized cost) totaled \$351,807,000 in 2018, a decrease of \$26,982,000 (7.1%) from 2017. Proceeds from maturities and calls of securities have been used to help fund loan growth and decrease borrowings over the course of 2017 and first six months of 2018. The average yield on available-for-sale debt securities decreased to 2.60% in 2018 from 2.82% in 2017. The reduction in yield on available-for-sale debt securities includes the impact of a reduced tax benefit on tax-exempt municipal bonds as a result of the reduction in the federal income tax rate.

**INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES**

Interest expense increased \$141,000, or 7.3%, to \$2,072,000 in 2018 from \$1,931,000 in 2017. Table III shows that the overall cost of funds on interest-bearing liabilities increased to 0.51% in 2018 from 0.48% in 2017.

Total average deposit balances (interest-bearing and noninterest-bearing) increased 4.1%, to \$1,013,113,000 in 2018 from \$973,640,000 in 2017. Increases in the average balances of demand deposits, certificates of deposit, interest checking and savings were partially offset by reductions in money market and Individual Retirement Accounts.

Interest expense on deposits increased \$512,000 in 2018 over 2017. The average rate on interest-bearing deposits increased to 0.42% in 2018 from 0.30% in 2017. Interest expense on certificates of deposit increased \$232,000 in 2018 of which \$167,000 is from an increase in average rate and \$65,000 due to an increase in volume. Interest expense on interest checking accounts increased \$211,000 in 2018 to \$394,000 from \$183,000 in 2017. This increase is primarily due to an increase in the average rate paid on qualifying accounts.

Interest expense on borrowed funds decreased \$371,000 in 2018 as compared to 2017, including a reduction in interest expense on long-term borrowings partially offset by an increase in interest expense on short-term borrowings. Total average borrowed funds decreased \$14,109,000 to \$55,517,000 in 2018 from \$69,626,000 in 2017. The average rate on total borrowed funds was 1.69% in 2018 compared to 2.42% in 2017.

Interest expense on short-term borrowings in 2018 exceeded interest expense in the same period of 2017 by \$159,000 as result of a series of advances from FHLB-Pittsburgh that mature in monthly amounts of \$3,000,000 through October 2018, as well as an increase in short-term interest rates. These short-term advances were originated in the third and fourth quarters of 2017 to pay off a portion of a total of \$37,000,000 in long-term borrowings that matured during that time period. Average short-term borrowings totaled \$37,878,000 for the first six months of 2018, an increase of \$6,638,000 over 2017. The weighted-average rate on short-term borrowings was 1.50% in 2018 as compared to 0.79% in 2017.



Interest expense on long-term debt decreased \$530,000 in 2018 as compared to 2017, mainly from repayment of the \$37 million in higher-cost borrowings (weighted-average rate of 3.65%) in the third and fourth quarters of 2017 as referred to above. Borrowings are classified as long-term within the Tables based on their term at origination. The average balance of long-term borrowings in 2018 of \$17,639,000 consisted mainly of FHLB advances maturing in early to mid-2019, and had a weighted-average rate of 2.09%. In comparison, average long-term borrowings in the same period of 2017 totaled \$38,386,000, with an average rate of 3.75%.

### **Three-Month Periods Ended June 30, 2018 and 2017**

For the three-month periods, fully taxable equivalent net interest income was \$11,586,000 in 2018, which was \$524,000 (4.7%) higher than in 2017. Interest income was \$625,000 higher in 2018 as compared to 2017, while interest expense was higher by \$101,000 in comparing the same periods. As presented in Table III, the Net Interest Margin was 3.87% in 2018 as compared to 3.83% in 2017, and the “Interest Rate Spread” (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.71% in 2018 as compared to 3.69% in 2017.

Interest income totaled \$12,665,000 in 2018, an increase of \$625,000 (5.2%) from 2017. Interest and fees from loans receivable increased \$908,000, or 9.7%, in 2018 as compared to 2017, while income from available-for-sale securities decreased \$337,000 (12.9%). As indicated in Table III, for the three-month periods, the average balance of gross loans receivable increased 7.0% to \$825,505,000 in 2018 from \$771,372,000 in 2017. The average rate of return on loans was 5.00% in 2018, up from 4.87% in 2017. Total average available-for-sale securities (at amortized cost) in 2018 decreased to \$350,610,000 from \$369,799,000 in 2017. The average rate of return on available-for-sale securities was 2.61% for 2018, down from 2.84% in 2017. The reduction in average rate of return on available-for-sale securities is a result of a reduced tax benefit on tax exempt municipal bonds due to the marginal tax rate decreasing to 21% in 2018 from 35% in 2017.

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For the three-month periods, interest expense increased \$101,000, or 10.3%, to \$1,079,000 in 2018 from \$978,000 in 2017. Interest expense on deposits increased \$304,000, as the average rate paid on deposits increased to 0.45% in 2018 from 0.31% in 2017, including increases of 0.33% on certificates of deposit and 0.18% on interest checking. Total average deposits (interest-bearing and noninterest-bearing) amounted to \$1,028,539,000 in the second quarter of 2018, an increase of \$48,553,000 (5.0%) over the second quarter 2017 total. The increase in total average deposits included an increase in interest bearing deposits of \$27,859,000 and an increase in noninterest-bearing demand deposits of \$20,694,000.

Interest expense on total borrowed funds decreased \$203,000 in 2018 as compared to 2017. Interest expense on short-term borrowings increased \$37,000 while interest expense on long-term borrowings decreased by \$240,000 in 2018 as compared to 2017. The average balance of total borrowed funds decreased to \$45,784,000 in the second quarter 2018 from \$59,558,000 in the second quarter 2017, while the average rate on borrowed funds decreased to 1.75% in the second quarter 2018 from 2.71% in the second quarter 2017.

Interest expense on short-term borrowings increased \$37,000 to \$82,000 in 2018 from \$45,000 in 2017. The increase in interest expense on short-term borrowings reflects the impact of higher short-term interest rates in 2018 as compared to 2017 as the average rate on short-term borrowings increased to 1.39% in 2018 from 0.85% in 2017. The average balance of short-term borrowings increased to \$23,610,000 in the second quarter 2018 from \$21,205,000 in the second quarter 2017.

The average balance of long-term borrowings was \$22,174,000 in the second quarter 2018, at an average rate of 2.13%, down from an average balance of \$38,353,000 at an average rate of 3.74% in the second quarter 2017. As described above, the reduction in average balance and rate on long-term borrowings reflects the repayment of higher cost borrowings totaling \$37,000,000 in the third and fourth quarters of 2017, with long-term borrowings in 2018 consisting mainly of FHLB advances maturing in early to mid-2019.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE**

| (In Thousands)                           | Three Months Ended |           |                         | Six Months Ended |          |                         |
|--|--------------------|-----------|-------------------------|------------------|----------|-------------------------|
|  | June 30,<br>2018   | 2017      | Increase/<br>(Decrease) | June 30,<br>2018 | 2017     | Increase/<br>(Decrease) |
| <b>INTEREST INCOME</b>                   |                    |           |                         |                  |          |                         |
| Available-for-sale debt securities:      |                    |           |                         |                  |          |                         |
| Taxable                                  | \$ 1,381           | \$ 1,352  | \$ 29                   | \$2,744          | \$2,755  | (\$ 11 )                |
| Tax-exempt                               | 897                | 1,263     | (366 )                  | 1,795            | 2,551    | (756 )                  |
| Total available-for-sale debt securities | 2,278              | 2,615     | (337 )                  | 4,539            | 5,306    | (767 )                  |
| Dividends on marketable equity security  | 6                  | 5         | 1                       | 11               | 10       | 1                       |
| Interest-bearing due from banks          | 96                 | 41        | 55                      | 146              | 73       | 73                      |
| Loans held for sale                      | 4                  | 6         | (2 )                    | 6                | 10       | (4 )                    |
| Loans receivable:                        |                    |           |                         |                  |          |                         |
| Taxable                                  | 9,575              | 8,609     | 966                     | 18,776           | 16,983   | 1,793                   |
| Tax-exempt                               | 706                | 764       | (58 )                   | 1,406            | 1,452    | (46 )                   |
| Total loans receivable                   | 10,281             | 9,373     | 908                     | 20,182           | 18,435   | 1,747                   |
| Total Interest Income                    | 12,665             | 12,040    | 625                     | 24,884           | 23,834   | 1,050                   |
| <b>INTEREST EXPENSE</b>                  |                    |           |                         |                  |          |                         |
| Interest-bearing deposits:               |                    |           |                         |                  |          |                         |
| Interest checking                        | 213                | 106       | 107                     | 394              | 183      | 211                     |
| Money market                             | 122                | 89        | 33                      | 215              | 170      | 45                      |
| Savings                                  | 38                 | 36        | 2                       | 75               | 70       | 5                       |
| Certificates of deposit                  | 389                | 238       | 151                     | 694              | 462      | 232                     |
| Individual Retirement Accounts           | 117                | 106       | 11                      | 230              | 211      | 19                      |
| Total interest-bearing deposits          | 879                | 575       | 304                     | 1,608            | 1,096    | 512                     |
| Borrowed funds:                          |                    |           |                         |                  |          |                         |
| Short-term                               | 82                 | 45        | 37                      | 281              | 122      | 159                     |
| Long-term                                | 118                | 358       | (240 )                  | 183              | 713      | (530 )                  |
| Total borrowed funds                     | 200                | 403       | (203 )                  | 464              | 835      | (371 )                  |
| Total Interest Expense                   | 1,079              | 978       | 101                     | 2,072            | 1,931    | 141                     |
| Net Interest Income                      | \$ 11,586          | \$ 11,062 | \$ 524                  | \$22,812         | \$21,903 | \$ 909                  |

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 21% for 2018 and 35% for 2017.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE III - ANALYSIS OF AVERAGE DAILY BALANCES AND RATES****(Dollars in Thousands)**

|  | 3 Months<br>Ended<br>6/30/2018<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 3 Months<br>Ended<br>6/30/2017<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 6 Months<br>Ended<br>6/30/2018<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 6 Months<br>Ended<br>6/30/2017<br>Average<br>Balance | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% |
|--|--|---|--|---|--|---|--|---|
| <b>EARNING ASSETS</b>                                  |  |   |  |   |  |   |  |   |
| Available-for-sale debt securities, at amortized cost: |  |   |  |   |  |   |  |   |
| Taxable  | \$247,809  | 2.24 %  | \$254,806  | 2.13 %  | \$248,819  | 2.22 %  | \$262,486  | 2.12 %  |
| Tax-exempt   | 102,801  | 3.50 %  | 114,993  | 4.41 %  | 102,988  | 3.51 %  | 116,303  | 4.42 %  |
| Total available-for-sale debt securities               | 350,610  | 2.61 %  | 369,799  | 2.84 %  | 351,807  | 2.60 %  | 378,789  | 2.82 %  |
| Marketable equity security                             | 952  | 2.53 %  | 1,000  | 2.01 %  | 957  | 2.32 %  | 1,000  | 2.02 %  |
| Interest-bearing due from banks                        | 22,286   | 1.73 %  | 14,873   | 1.11 %  | 18,231   | 1.61 %  | 14,898   | 0.99 %  |
| Loans held for sale                                    | 267  | 6.01 %  | 499  | 4.82 %  | 218  | 5.55 %  | 351  | 5.75 %  |
| Loans receivable:                                      |  |   |  |   |  |   |  |   |
| Taxable  | 747,889  | 5.14 %  | 702,933  | 4.91 %  | 744,292  | 5.09 %  | 700,501  | 4.89 %  |
| Tax-exempt   | 77,616   | 3.65 %  | 68,439   | 4.48 %  | 76,933   | 3.69 %  | 64,907   | 4.51 %  |
| Total loans receivable                                 | 825,505  | 5.00 %  | 771,372  | 4.87 %  | 821,225  | 4.96 %  | 765,408  | 4.86 %  |
| Total Earning Assets                                   | 1,199,620  | 4.23 %  | 1,157,543  | 4.17 %  | 1,192,438  | 4.21 %  | 1,160,446  | 4.14 %  |
| Cash   | 18,010   |   | 17,276   |   | 17,445   |   | 16,648   |   |
| Unrealized gain/loss on securities                     | (8,242 )   |   | 689  |   | (6,893 )   |   | (130 )   |   |
| Allowance for loan losses                              | (9,161 )   |   | (8,901 )   |   | (9,082 )   |   | (8,748 )   |   |
| Bank premises and equipment                            | 15,425   |   | 15,714   |   | 15,438   |   | 15,713   |   |
| Intangible Assets                                      | 11,952   |   | 11,957   |   | 11,953   |   | 11,958   |   |
| Other assets   | 41,575   |   | 41,322   |   | 42,174   |   | 42,594   |   |
| Total Assets   | \$1,269,179  |   | \$1,235,600  |   | \$1,263,473  |   | \$1,238,481  |   |
| <b>INTEREST-BEARING LIABILITIES</b>                    |  |   |  |   |  |   |  |   |
| Interest-bearing deposits:                             |  |   |  |   |  |   |  |   |
| Interest checking                                      | \$217,607  | 0.39 %  | \$203,256  | 0.21 %  | \$215,307  | 0.37 %  | \$202,194  | 0.18 %  |
| Money market   | 180,667  | 0.27 %  | 190,703  | 0.19 %  | 180,297  | 0.24 %  | 190,902  | 0.18 %  |
| Savings  | 152,663  | 0.10 %  | 142,978  | 0.10 %  | 151,149  | 0.10 %  | 140,903  | 0.10 %  |
| Certificates of deposit                                | 135,429  | 1.15 %  | 116,450  | 0.82 %  | 129,733  | 1.08 %  | 115,051  | 0.81 %  |

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|   |             |        |             |        |             |        |             |        |
|---|-------------|--------|-------------|--------|-------------|--------|-------------|--------|
| Individual Retirement Accounts                                  | 92,899      | 0.51 % | 98,004      | 0.43 % | 93,601      | 0.50 % | 98,513      | 0.43 % |
| Other time deposits   | 1,092       | 0.00 % | 1,107       | 0.00 % | 933         | 0.00 % | 950         | 0.00 % |
| Total interest-bearing deposits                                 | 780,357     | 0.45 % | 752,498     | 0.31 % | 771,020     | 0.42 % | 748,513     | 0.30 % |
| Borrowed funds:   |             |        |             |        |             |        |             |        |
| Short-term  | 23,610      | 1.39 % | 21,205      | 0.85 % | 37,878      | 1.50 % | 31,240      | 0.79 % |
| Long-term   | 22,174      | 2.13 % | 38,353      | 3.74 % | 17,639      | 2.09 % | 38,386      | 3.75 % |
| Total borrowed funds  | 45,784      | 1.75 % | 59,558      | 2.71 % | 55,517      | 1.69 % | 69,626      | 2.42 % |
| Total Interest-bearing Liabilities                              | 826,141     | 0.52 % | 812,056     | 0.48 % | 826,537     | 0.51 % | 818,139     | 0.48 % |
| Demand deposits   | 248,182     |        | 227,488     |        | 242,093     |        | 225,127     |        |
| Other liabilities   | 8,848       |        | 7,573       |        | 8,859       |        | 7,866       |        |
| Total Liabilities   | 1,083,171   |        | 1,047,117   |        | 1,077,489   |        | 1,051,132   |        |
| Stockholders' equity, excluding other comprehensive income/loss | 192,375     |        | 187,882     |        | 191,258     |        | 187,289     |        |
| Accumulated other comprehensive income/loss                     | (6,367 )    |        | 601         |        | (5,274 )    |        | 60          |        |
| Total Stockholders' Equity                                      | 186,008     |        | 188,483     |        | 185,984     |        | 187,349     |        |
| Total Liabilities and Stockholders' Equity                      | \$1,269,179 |        | \$1,235,600 |        | \$1,263,473 |        | \$1,238,481 |        |
| Interest Rate Spread  |             | 3.71 % |             | 3.69 % |             | 3.70 % |             | 3.66 % |
| Net Interest Income/Earning Assets                              |             | 3.87 % |             | 3.83 % |             | 3.86 % |             | 3.81 % |
| Total Deposits (Interest-bearing and Demand)                    | \$1,028,539 |        | \$979,986   |        | \$1,013,113 |        | \$973,640   |        |

(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 21% in 2018 and 35% in 2017.

(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.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE IV - ANALYSIS OF VOLUME AND RATE CHANGES**

| (In Thousands)                           | 3 Months Ended 6/30/18 vs. 6/30/17 |                   |                 | 6 Months Ended 6/30/18 vs. 6/30/17 |                   |                 |
|--|------------------------------------|-------------------|-----------------|------------------------------------|-------------------|-----------------|
|  | Change in<br>Volume                | Change in<br>Rate | Total<br>Change | Change in<br>Volume                | Change in<br>Rate | Total<br>Change |
| <b>EARNING ASSETS</b>                    |                                    |                   |                 |                                    |                   |                 |
| Available-for-sale debt securities:      |                                    |                   |                 |                                    |                   |                 |
| Taxable                                  | \$ (38 )                           | \$ 67             | \$ 29           | \$ (147 )                          | \$ 136            | \$ (11 )        |
| Tax-exempt                               | (125 )                             | (241 )            | (366 )          | (271 )                             | (485 )            | (756 )          |
| Total available-for-sale debt securities | (163 )                             | (174 )            | (337 )          | (418 )                             | (349 )            | (767 )          |
| Marketable equity security               | 0                                  | 1                 | 1               | 0                                  | 1                 | 1               |
| Interest-bearing due from banks          | 21                                 | 34                | 55              | 19                                 | 54                | 73              |
| Loans held for sale                      | (3 )                               | 1                 | (2 )            | (4 )                               | 0                 | (4 )            |
| Loans receivable:                        |                                    |                   |                 |                                    |                   |                 |
| Taxable                                  | 566                                | 400               | 966             | 1,088                              | 705               | 1,793           |
| Tax-exempt                               | 94                                 | (152 )            | (58 )           | 244                                | (290 )            | (46 )           |
| Total loans receivable                   | 660                                | 248               | 908             | 1,332                              | 415               | 1,747           |
| Total Interest Income                    | 515                                | 110               | 625             | 929                                | 121               | 1,050           |
| <b>INTEREST-BEARING LIABILITIES</b>      |                                    |                   |                 |                                    |                   |                 |
| Interest-bearing deposits:               |                                    |                   |                 |                                    |                   |                 |
| Interest checking                        | 8                                  | 99                | 107             | 13                                 | 198               | 211             |
| Money market                             | (5 )                               | 38                | 33              | (10 )                              | 55                | 45              |
| Savings                                  | 2                                  | 0                 | 2               | 5                                  | 0                 | 5               |
| Certificates of deposit                  | 44                                 | 107               | 151             | 65                                 | 167               | 232             |
| Individual Retirement Accounts           | (6 )                               | 17                | 11              | (11 )                              | 30                | 19              |
| Total interest-bearing deposits          | 43                                 | 261               | 304             | 62                                 | 450               | 512             |
| Borrowed funds:                          |                                    |                   |                 |                                    |                   |                 |
| Short-term                               | 6                                  | 31                | 37              | 30                                 | 129               | 159             |
| Long-term                                | (121 )                             | (119 )            | (240 )          | (292 )                             | (238 )            | (530 )          |
| Total borrowed funds                     | (115 )                             | (88 )             | (203 )          | (262 )                             | (109 )            | (371 )          |
| Total Interest Expense                   | (72 )                              | 173               | 101             | (200 )                             | 341               | 141             |
| Net Interest Income                      | \$ 587                             | \$ (63 )          | \$ 524          | \$ 1,129                           | \$ (220 )         | \$ 909          |

(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 21% for 2018 and 35% for 2017.

(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.



**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****NONINTEREST INCOME****TABLE V - COMPARISON OF NONINTEREST INCOME****(Dollars in Thousands)**

|   | 6 Months Ended   |         | \$      | %       |
|---|------------------|---------|---------|---------|
|   | June 30,<br>2018 | 2017    |         |         |
| Trust and financial management revenue                                | \$2,948          | \$2,677 | \$271   | 10.1    |
| Brokerage revenue   | 483              | 364     | 119     | 32.7    |
| Insurance commissions, fees and premiums                              | 57               | 72      | (15 )   | (20.8 ) |
| Service charges on deposit accounts                                   | 2,506            | 2,213   | 293     | 13.2    |
| Service charges and fees  | 168              | 166     | 2       | 1.2     |
| Interchange revenue from debit card transactions                      | 1,220            | 1,088   | 132     | 12.1    |
| Net gains from sales of loans   | 350              | 354     | (4 )    | (1.1 )  |
| Loan servicing fees, net  | 189              | 127     | 62      | 48.8    |
| Increase in cash surrender value of life insurance                    | 195              | 184     | 11      | 6.0     |
| Other noninterest income  | 979              | 725     | 254     | 35.0    |
| Total noninterest income, excluding gains (losses) on securities, net | \$9,095          | \$7,970 | \$1,125 | 14.1    |

Table V excludes the gain on a restricted equity security (Visa Class B stock) and net (losses) gains on available-for-sale debt securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table V increased \$1,125,000 (14.1%) in the first six months of 2018 over the first six months of 2017 amount. The most significant variances include the following:

Service charges on deposit accounts increased \$293,000 (13.2%), mainly due to increased fees from the overdraft privilege program and reflecting the benefit of operational improvements to the program that were instituted early in 2018.

Trust and financial management revenue increased \$271,000 (10.1%). The increase included the effects of a mid-year 2017 increase in fee levels and an increase in the value of assets under management to \$927,089,000 at June 30, 2018, up 3.6% from one year earlier. The increase in value of Trust assets under management resulted from appreciation in equity values and new business.

Interchange revenue from debit card transactions increased \$132,000 (12.1%), reflecting an increase in volume of transactions.



As a result of increased volume, broker-dealer revenue increased \$119,000 (32.7%).

Loan servicing fees, net, increased \$62,000. This category includes fees received from servicing residential mortgage loans that have been originated and sold, adjusted for changes in the fair value of servicing rights. The fair value of mortgage servicing rights decreased by \$26,000 in the first six months of 2018 as compared to a reduction of \$78,000 in the same period of 2017.

Other noninterest income increased \$254,000, including an increase of \$131,000 in state tax benefits from tax credits, primarily as a result of the donation of the Towanda building. Also, dividends on FHLB-Pittsburgh stock increased \$70,000 and interchange revenue from credit card transactions increased \$48,000.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE VI - COMPARISON OF NONINTEREST INCOME****(Dollars in Thousands)**

|   | 3 Months Ended   |          |              |             |
|---|------------------|----------|--------------|-------------|
|   | June 30,<br>2018 | 2017     | \$<br>Change | %<br>Change |
| Trust and financial management revenue                                | \$ 1,526         | \$ 1,497 | \$ 29        | 1.9         |
| Brokerage revenue   | 271              | 208      | 63           | 30.3        |
| Insurance commissions, fees and premiums                              | 13               | 31       | (18 )        | (58.1 )     |
| Service charges on deposit accounts                                   | 1,302            | 1,112    | 190          | 17.1        |
| Service charges and fees  | 82               | 86       | (4 )         | (4.7 )      |
| Interchange revenue from debit card transactions                      | 641              | 568      | 73           | 12.9        |
| Net gains from sales of loans   | 166              | 188      | (22 )        | (11.7 )     |
| Loan servicing fees, net  | 61               | 55       | 6            | 10.9        |
| Increase in cash surrender value of life insurance                    | 98               | 94       | 4            | 4.3         |
| Other noninterest income  | 529              | 267      | 262          | 98.1        |
| Total noninterest income, excluding gains (losses) on securities, net | \$ 4,689         | \$ 4,106 | \$ 583       | 14.2        |

Table VI excludes the gain on a restricted equity security (Visa Class B stock) and net (losses) gains on available-for-sale debt securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table VI increased \$583,000 (14.2%) in the second quarter 2018 over the second quarter of 2017 amount. The most significant variances include the following:

Service charges on deposit accounts increased \$190,000 (17.1%) in the second quarter 2018 over the second quarter 2017 total, mainly due to increased fees from the overdraft privilege program and reflecting the benefit of operational improvements to the program that were instituted early in 2018.

Interchange revenue from debit card transactions increased \$73,000 (12.9%), reflecting an increase in volume of transactions.

As a result of increased volume, broker-dealer revenue increased \$63,000 (30.3%).

Other noninterest income increased \$262,000 in the second quarter 2018 as compared to the second quarter 2017, including an increase of \$154,000 in state tax benefits from tax credits resulting from the second quarter 2018 donation of the Towanda building. Also, dividends on FHLB-Pittsburgh stock increased \$40,000 and interchange revenue from credit card transactions increased \$26,000.



**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****NONINTEREST EXPENSE****TABLE VII - COMPARISON OF NONINTEREST EXPENSE****(Dollars In Thousands)**

|  | Six Months Ended |          | \$      | %      |
|--|------------------|----------|---------|--------|
|  | June 30,<br>2018 | 2017     |         |        |
| Salaries and wages                               | \$8,317          | \$7,840  | \$477   | 6.1    |
| Pensions and other employee benefits             | 2,810            | 2,661    | 149     | 5.6    |
| Occupancy expense, net                           | 1,250            | 1,178    | 72      | 6.1    |
| Furniture and equipment expense                  | 584              | 628      | (44 )   | (7.0 ) |
| Data processing expenses                         | 1,335            | 1,190    | 145     | 12.2   |
| Automated teller machine and interchange expense | 641              | 599      | 42      | 7.0    |
| Pennsylvania shares tax                          | 672              | 672      | 0       | 0.0    |
| Professional fees                                | 555              | 375      | 180     | 48.0   |
| Telecommunications                               | 390              | 266      | 124     | 46.6   |
| Directors' fees                                  | 352              | 371      | (19 )   | (5.1 ) |
| Other noninterest expense                        | 2,673            | 2,594    | 79      | 3.0    |
| Total noninterest expense                        | \$19,579         | \$18,374 | \$1,205 | 6.6    |

As shown in Table VII, total noninterest expense increased \$1,205,000 (6.6%) in the first six months of 2018 as compared to the first six months of 2017. The most significant variances include the following:

Salaries and wages expense increased \$477,000 (6.1%), including the effects of annual performance-based salary adjustments for a majority of employees along with an increase of \$159,000 in estimated cash and stock-based compensation expense and an increase in the average number of FTEs to 295 in the first six months of 2018 from 290 in the first six months of 2017.

Professional fees were \$180,000 higher in 2018 than in 2017. The increase in professional fees included expenses in the first six months of 2018 related to implementation of a new mortgage loan origination system, completion of a consulting project related to Board governance and committee structure, assistance with implementation of new accounting standards, certification of a compliance-related software system and other corporate projects.

Pensions and other employee benefits expense increased \$149,000, including an increase of \$131,000 in health care expenses due to higher claims on the partially self-insured plan.

Data processing expenses increased \$145,000, including costs associated with the new mortgage loan origination system.

Telecommunications expense increased \$124,000 as a result of additional costs related to a new telephone system, along with costs from the prior legacy system during the transition period.

Occupancy costs increased \$72,000, primarily due to increases in fuel and maintenance costs.

Other noninterest expense increased \$79,000. Within this category, the most significant fluctuations between 2018 and comparative 2017 were as follows:

The donation of the Towanda property was completed in June 2018, resulting in recognition of expense of \$250,000 based on the net book value of the real estate. Accordingly, donation expense in the first six months of 2018 exceeded the 2017 total by \$227,000.

Ø Credit card processing and rewards redemption expense increased \$51,000.

Ø Collection expense, net of reimbursements, was \$105,000 lower in 2018.

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Recoveries of sales and use tax previously paid totaled \$40,000 in the first six months of 2018, resulting in a reduction in expense. In comparison, expense associated with sales and use tax assessments totaling \$65,000 was recognized in the first six months of 2017.

**TABLE VIII - COMPARISON OF NONINTEREST EXPENSE****(Dollars In Thousands)**

|  | Three Months Ended |          |              |             |
|--|--------------------|----------|--------------|-------------|
|  | June 30,<br>2018   | 2017     | \$<br>Change | %<br>Change |
| Salaries and wages                               | \$ 4,193           | \$ 3,972 | \$ 221       | 5.6         |
| Pensions and other employee benefits             | 1,200              | 1,137    | 63           | 5.5         |
| Occupancy expense, net                           | 613                | 600      | 13           | 2.2         |
| Furniture and equipment expense                  | 313                | 315      | (2 )         | (0.6 )      |
| Data processing expenses                         | 694                | 615      | 79           | 12.8        |
| Automated teller machine and interchange expense | 319                | 305      | 14           | 4.6         |
| Pennsylvania shares tax                          | 336                | 336      | 0            | 0.0         |
| Professional fees                                | 279                | 188      | 91           | 48.4        |
| Telecommunications                               | 157                | 132      | 25           | 18.9        |
| Directors' fees                                  | 168                | 186      | (18 )        | (9.7 )      |
| Other noninterest expense                        | 1,412              | 1,290    | 122          | 9.5         |
| Total noninterest expense                        | \$ 9,684           | \$ 9,076 | \$ 608       | 6.7         |

As shown in Table VIII, total noninterest expense increased \$608,000 (6.7%) in the second quarter 2018 as compared to the second quarter 2017. The most significant variances include the following:

Salaries and wages expense increased \$221,000 (5.6%), including the effects of annual performance-based salary adjustments for a majority of employees along with an increase of \$73,000 in estimated cash and stock-based compensation expense and an increase in the average number of FTEs to 297 in the second quarter 2018 from 292 in the second quarter 2017.

Professional fees were \$91,000 higher in the second quarter 2018 than in the second quarter 2017, including expenses in the second quarter 2018 related to implementation of the new mortgage loan origination system, assistance with implementation of new accounting standards, certification of a compliance-related software system and other corporate projects.

Data processing expenses increased \$79,000, including costs associated with the new mortgage loan origination system.

Pensions and other employee benefits expense increased \$63,000, including an increase of \$32,000 in health care expenses due to higher claims on the partially self-insured plan.

Other noninterest expense increased \$122,000. Within this category, donations expense increased \$226,000, including the second quarter 2018 expense of \$250,000 from donation of the Towanda real estate as described above. Recoveries of sales and use tax previously paid totaled \$37,000 in the second quarter 2018, resulting in a reduction in expense, while second quarter 2017 expense included sales and use tax assessments totaling \$65,000.

## **INCOME TAXES**

The income tax provision in interim periods is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The income tax provision for the first six months of 2018 was \$2,118,000, or 16.5% of pre-tax earnings, which was \$240,000 lower than the provision for the first six months of 2017 of \$2,358,000, or 23.8% of pre-tax income. The Corporation benefited from the reduction in the federal corporate income tax rate to 21%, effective January 1, 2018, from the 35% marginal tax rate in effect throughout 2017. The Corporation's effective tax rates differ from the statutory rate of 21% in the first six months of 2018 and 35% for the first six months of 2017 principally because of the effects of tax-exempt interest income.

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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 June 30, 2018 the net deferred tax asset was \$4,304,000, up from \$3,289,000 at December 31, 2017. The most significant change in temporary difference components was a net increase of \$1,215,000 related to unrealized losses on available-for-sale securities. At June 30, 2018, the net deferred tax asset associated with the unrealized loss was \$1,721,000, while at December 31, 2017, the deferred tax asset associated with the unrealized loss was \$506,000, including \$843,000 recorded as an offset to the pre-tax unrealized loss within accumulated other comprehensive loss, partially offset by \$337,000 charged against retained earnings.

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 June 30, 2018 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.

**FINANCIAL CONDITION**

This section includes information regarding the Corporation's lending activities or other significant changes or exposures that are not otherwise addressed in Management's Discussion and Analysis. 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. There are no significant concerns that have arisen related to the Corporation's off-balance sheet loan commitments or outstanding standby letters of credit at June 30, 2018, and management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition in 2018.

Gross loans outstanding (excluding mortgage loans held for sale) were \$818,647,000 at June 30, 2018, up 0.4% from \$815,713,000 at December 31, 2017 and 5.0% from \$779,692,000 at June 30, 2017. Total outstanding mortgages and other consumer real estate loans were \$2,474,000 (0.6%) higher at June 30, 2018 as compared to December 31, 2017



and increased \$19,781,000 (4.6%) as compared to June 30, 2017. Total outstanding commercial loans were lower by \$507,000 (0.1%) at June 30, 2018 as compared to December 31, 2017 and \$17,891,000 (5.3%) higher compared to June 30, 2017. The reduction in outstanding commercial loans at June 30, 2018 reflected pay-offs totaling approximately \$13,000,000 from a few large loans that occurred late in the second quarter. Average loans outstanding in the first six months of 2018 of \$821,225,000 were \$55,817,000 (7.3%) higher than the corresponding total in the first six months of 2017.

While the Corporation's lending activities are primarily concentrated in its market area, a portion of the Corporation's commercial loan segment consists of 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", "Political subdivisions" and "Other commercial" classes in the loan tables presented in this Form 10-Q. Total participation loans outstanding amounted to \$62,949,000 at June 30, 2018, up from \$61,245,000 at December 31, 2017 and \$42,876,000 at June 30, 2017. At June 30, 2018, the balance of participation loans outstanding includes a total of \$52,681,000 to businesses located outside of the Corporation's market area, including \$9,684,000 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 at the time of origination the businesses have demonstrated strong cash flow performance in their recent histories. Total leveraged participation loans, including loans originated through the network and two loans originated through another lead institution, totaled \$13,944,000 at June 30, 2018 and \$15,328,000 at December 31, 2017.

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 quasi-government entity. 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.

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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 June 30, 2018, the total outstanding balance of loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to \$1,780,000, and the corresponding total outstanding balance repurchased at December 31, 2017 was \$1,805,000.

At June 30, 2018, outstanding balances of loans sold and serviced through the two programs totaled \$171,543,000, including loans sold through the MPF Xtra program of \$102,533,000 and loans sold through the Original program of \$69,010,000. At December 31, 2017, outstanding balances of loans sold and serviced through the two programs totaled \$169,725,000, including loans sold through the MPF Xtra program of \$107,117,000 and loans sold through the Original program of \$62,608,000. Based on the fairly limited volume of required repurchases to date, no allowance has been established for representation and warranty exposures as of June 30, 2018 and December 31, 2017.

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 June 30, 2018, the Corporation’s maximum credit enhancement obligation under the MPF Original Program was \$3,623,000, and the Corporation has recorded a related allowance for credit losses of \$300,000 which is included in “Accrued interest and other liabilities” in the accompanying consolidated balance sheets. At December 31, 2017, the Corporation’s maximum credit enhancement obligation under the MPF Original Program was \$5,742,000, and the related allowance for credit losses was \$260,000. The Corporation does not provide a credit enhancement for loans sold through the Xtra program.

**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 \$8,831,000 at June 30, 2018, down from \$8,856,000 at December 31, 2017. Table X shows total specific allowances on impaired loans decreased \$184,000 to \$1,095,000 at June 30, 2018 from \$1,279,000 at December 31, 2017. The largest individual loan balance for which a specific allowance has been recorded is a real estate secured commercial loan with an outstanding balance of \$2,573,000 and a specific allowance of \$850,000 at June 30, 2018, down from an outstanding balance of \$2,641,000 and a specific allowance of \$919,000 at December 31, 2017.

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The provision for loan losses by segment in the three-month and six-month period ended June 30, 2018 and 2017 is as follows:

| (In Thousands)       | 3 Months Ended |               | 6 Months Ended |               |
|----------------------|----------------|---------------|----------------|---------------|
|                      | June 30, 2018  | June 30, 2017 | June 30, 2018  | June 30, 2017 |
| Residential mortgage | \$ 47          | \$ 39         | \$ 78          | \$ 168        |
| Commercial           | (120 )         | (150 )        | 97             | 153           |
| Consumer             | 53             | 13            | 97             | 33            |
| Unallocated          | 0              | 102           | 0              | 102           |
| Total                | \$ (20 )       | \$ 4          | \$ 272         | \$ 456        |

The provision for loan losses is further detailed as follows:

|   | 3 Months Ended June 30, 2018 | 3 Months Ended June 30, 2017 | 6 Months Ended June 30, 2018 | 6 Months Ended June 30, 2017 |
|---|------------------------------|------------------------------|------------------------------|------------------------------|
| Residential mortgage segment<br>(In thousands)  |                              |                              |                              |                              |
| Increase in total specific allowance on impaired loans, adjusted for the effect of net charge-offs            | \$ 41                        | \$ 102                       | \$ 92                        | \$ 162                       |
| Increase (decrease) in collectively determined portion of the allowance attributable to:                      |                              |                              |                              |                              |
| Loan growth   | 43                           | 11                           | 23                           | 48                           |
| Changes in historical loss experience factors   | (37 )                        | 7                            | (37 )                        | 39                           |
| Changes in qualitative factors  | 0                            | (81 )                        | 0                            | (81 )                        |
| Total provision for loan losses - Residential mortgage segment  | \$ 47                        | \$ 39                        | \$ 78                        | \$ 168                       |
| Commercial segment<br>(In thousands)  |                              |                              |                              |                              |
| (Decrease) increase in total specific allowance on impaired loans, adjusted for the effect of net charge-offs | \$ (142 )                    | \$ 202                       | \$ (31 )                     | \$ 504                       |
| (Decrease) increase in collectively determined portion of the allowance attributable to:                      |                              |                              |                              |                              |
| Loan (reduction) growth   | (18 )                        | 32                           | 35                           | 45                           |

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|   |           |           |       |        |
|---|-----------|-----------|-------|--------|
| Changes in historical loss experience factors                 | 40        | (305 )    | 93    | (262 ) |
| Changes in qualitative factors                                | 0         | (79 )     | 0     | (134 ) |
| Total (credit) provision for loan losses - Commercial segment | \$ (120 ) | \$ (150 ) | \$ 97 | \$ 153 |

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|   | 3<br>Months<br>Ended<br>June 30,<br>2018 | 3<br>Months<br>Ended<br>June 30,<br>2017 | 6<br>Months<br>Ended<br>June 30,<br>2018 | 6<br>Months<br>Ended<br>June 30,<br>2017 |
|---|--|--|--|--|
| Consumer segment<br>(In thousands)  |  |  |  |  |
| Increase in total specific allowance on impaired loans, adjusted for the effect of net charge-offs            | \$ 23                                    | \$ 11                                    | \$ 52                                    | \$ 37                                    |
| Increase (decrease) in collectively determined portion of the allowance attributable to:                      |  |  |  |  |
| Loan growth   | 5  | 5  | 9  | 7  |
| Changes in historical loss experience factors   | 16                                       | (2 )                                     | 26                                       | (9 )                                     |
| Changes in qualitative factors  | 9  | (1 )                                     | 10                                       | (2 )                                     |
| Total provision for loan losses - Consumer segment  | \$ 53                                    | \$ 13                                    | \$ 97                                    | \$ 33                                    |
|   |  |  |  |  |
|   | 3<br>Months<br>Ended<br>June 30,<br>2018 | 3<br>Months<br>Ended<br>June 30,<br>2017 | 6<br>Months<br>Ended<br>June 30,<br>2018 | 6<br>Months<br>Ended<br>June 30,<br>2017 |
| Total - All segments<br>(In thousands)  |  |  |  |  |
| (Decrease) increase in total specific allowance on impaired loans, adjusted for the effect of net charge-offs | \$ (78 )                                 | \$ 315                                   | \$ 113                                   | \$ 703                                   |
| Increase (decrease) in collectively determined portion of the allowance attributable to:                      |  |  |  |  |
| Loan growth   | 30                                       | 48                                       | 67                                       | 100                                      |
| Changes in historical loss experience factors   | 19                                       | (300 )                                   | 82                                       | (232 )                                   |
| Changes in qualitative factors  | 9  | (161 )                                   | 10                                       | (217 )                                   |
| Sub-total   | (20 )                                    | (98 )                                    | 272                                      | 354                                      |
| Unallocated   | 0  | 102                                      | 0  | 102                                      |
| Total (credit) provision for loan losses - All segments   | \$ (20 )                                 | \$ 4                                     | \$ 272                                   | \$ 456                                   |

For the periods shown in the tables immediately above, the provision related to increases or decreases in specific allowances on impaired loans was affected by changes in the results of management's assessment of the amount of probable or actual (charged-off) losses associated with a small number of larger, individual loans. This line item also includes net charge-offs or recoveries from smaller loans that had not been individually evaluated for impairment prior to charge-off. In the second quarter 2018, the credit for the commercial segment included the benefit of reversing a specific allowance of \$158,000 that had been previously established. The reversal of this specific allowance resulted from an improvement in the Corporation's collateral position.

In the tables immediately above, the portion of the net change in the collectively determined allowance attributable to loan growth was determined by applying the historical loss experience and qualitative factors used in the allowance calculation at the end of the preceding period to the net increase in loans outstanding (excluding loans specifically

evaluated for impairment) for the period.

The effect on the provision of changes in historical loss experience and qualitative factors, as shown in the tables above, was determined by: (1) calculating the net change in each factor used in determining the allowance at the end of the period as compared to the preceding period, and (2) applying the net change in each factor to the outstanding balance of loans at the end of the preceding period (excluding loans specifically evaluated for impairment).

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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 1.76% at June 30, 2018, down from 2.10% at December 31, 2017, and nonperforming assets as a percentage of total assets was 1.35% at June 30, 2018, down from 1.47% at December 31, 2017. Table XI presents data at June 30, 2018 and at the end of each of the years ended December 31, 2013 through 2017. For the range of dates presented in Table XI, total nonperforming loans as a percentage of loans has ranged from a low of 1.76% at June 30, 2018 to a high of 2.80% at December 31, 2013, and total nonperforming assets as a percentage of assets have ranged from a low of 1.31% at December 31, 2015 to a high of 1.53% at December 31, 2013.

Total impaired loans of \$7,998,000 at June 30, 2018 are down \$1,513,000 from the corresponding amount at December 31, 2017 of \$9,511,000, while foreclosed assets held for sale increased \$1,299,000 to a balance of \$2,897,000 at June 30, 2018. In the second quarter 2018, the Corporation acquired two properties that had secured a commercial loan, recording the acquisition at an estimated fair value of \$2,293,000 with no gain or loss recognized. Table XI shows that the total outstanding balance of impaired loans of \$7,998,000 at June 30, 2018 is lower than the year-end balances from 2013 – 2017, while the balance of foreclosed assets held for sale is higher than the year-end amounts for the previous five years.

Total nonperforming assets of \$17,322,000 at June 30, 2018 are \$1,404,000 lower than the corresponding amount at December 31, 2017, summarized as follows:

Total nonaccrual loans at June 30, 2018 of \$11,230,000 was \$2,174,000 lower than the corresponding December 31, 2017 total of \$13,404,000, including the effect of reducing nonaccrual loans due to the acquisition of the commercial properties as described above.

Total loans past due 90 days or more and still accruing interest amounted to \$3,195,000 at June 30, 2018, a decrease of \$529,000 from the total at December 31, 2017. The reduction in loans past due 90 days or more included a reduction in residential mortgage loans of \$672,000 and an increase in commercial loans of \$124,000. 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 \$2,897,000 at June 30, 2018, an increase of \$1,299,000 from \$1,598,000 at December 31, 2017. At June 30, 2018, the Corporation held 13 such properties for sale, with total carrying values of \$412,000 related to residential real estate, \$120,000 of land and \$2,365,000 related to commercial real estate. At December 31, 2017, the Corporation held 16 such properties for sale, with total carrying values of \$721,000 related to residential real estate, \$632,000 of land and \$245,000 related to commercial real estate. The Corporation evaluates the carrying values of foreclosed assets each quarter based on the most recent market activity or appraisals for each property.



Over the period 2013-2017 and the first six months of 2018, each period 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 June 30, 2018. 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.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE IX - ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES****(Dollars In Thousands)**

|   | Six Months Ended |               |                          |         |         |         |         |
|---|------------------|---------------|--------------------------|---------|---------|---------|---------|
|   | June 30, 2018    | June 30, 2017 | Years Ended December 31, |         |         |         | 2013    |
|   | 2018             | 2017          | 2017                     | 2016    | 2015    | 2014    | 2013    |
| Balance, beginning of year              | \$8,856          | \$8,473       | \$8,473                  | \$7,889 | \$7,336 | \$8,663 | \$6,857 |
| Charge-offs:                            |                  |               |                          |         |         |         |         |
| Residential mortgage                    | (99 )            | (178 )        | (197 )                   | (73 )   | (217 )  | (327 )  | (95 )   |
| Commercial                              | (154 )           | (97 )         | (132 )                   | (597 )  | (251 )  | (1,715) | (459 )  |
| Consumer                                | (73 )            | (60 )         | (150 )                   | (87 )   | (94 )   | (97 )   | (117 )  |
| Total charge-offs                       | (326 )           | (335 )        | (479 )                   | (757 )  | (562 )  | (2,139) | (671 )  |
| Recoveries:                             |                  |               |                          |         |         |         |         |
| Residential mortgage                    | 5                | 16            | 19                       | 3       | 1       | 25      | 24      |
| Commercial                              | 3                | 2             | 4                        | 35      | 214     | 264     | 348     |
| Consumer                                | 21               | 23            | 38                       | 82      | 55      | 47      | 58      |
| Total recoveries                        | 29               | 41            | 61                       | 120     | 270     | 336     | 430     |
| Net charge-offs                         | (297 )           | (294 )        | (418 )                   | (637 )  | (292 )  | (1,803) | (241 )  |
| Provision for loan losses               | 272              | 456           | 801                      | 1,221   | 845     | 476     | 2,047   |
| Balance, end of period                  | \$8,831          | \$8,635       | \$8,856                  | \$8,473 | \$7,889 | \$7,336 | \$8,663 |
| Net charge-offs as a % of average loans | 0.04 %           | 0.04 %        | 0.05 %                   | 0.09 %  | 0.04 %  | 0.29 %  | 0.04 %  |

**TABLE X - COMPONENTS OF THE ALLOWANCE FOR LOAN LOSSES****(In Thousands)**

|                                | June 30, | As of December 31, |         |         |         |         |
|--------------------------------|----------|--------------------|---------|---------|---------|---------|
|                                | 2018     | 2017               | 2016    | 2015    | 2014    | 2013    |
| ASC 310 - Impaired loans       | \$ 1,095 | \$1,279            | \$674   | \$820   | \$769   | \$2,333 |
| ASC 450 - Collective segments: |          |                    |         |         |         |         |
| Commercial                     | 3,206    | 3,078              | 3,373   | 3,103   | 2,732   | 2,583   |
| Residential mortgage           | 3,827    | 3,841              | 3,890   | 3,417   | 3,295   | 3,156   |
| Consumer                       | 204      | 159                | 138     | 122     | 145     | 193     |
| Unallocated                    | 499      | 499                | 398     | 427     | 395     | 398     |
| Total Allowance                | \$ 8,831 | \$8,856            | \$8,473 | \$7,889 | \$7,336 | \$8,663 |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE XI - PAST DUE AND IMPAIRED LOANS, NONPERFORMING ASSETS****AND TROUBLED DEBT RESTRUCTURINGS (TDRs)****(Dollars In Thousands)**

|   | June 30, |          | As of December 31, |          |          |          |
|---|----------|----------|--------------------|----------|----------|----------|
|   | 2018     | 2017     | 2016               | 2015     | 2014     | 2013     |
| Impaired loans with a valuation allowance               | \$3,652  | \$4,100  | \$3,372            | \$1,933  | \$3,241  | \$9,889  |
| Impaired loans without a valuation allowance            | 4,346    | 5,411    | 7,488              | 8,041    | 9,075    | 6,432    |
| Total impaired loans                                    | \$7,998  | \$9,511  | \$10,860           | \$9,974  | \$12,316 | \$16,321 |
| Total loans past due 30-89 days and still accruing      | \$3,921  | \$9,449  | \$7,735            | \$7,057  | \$7,121  | \$8,305  |
| Nonperforming assets:                                   |          |          |                    |          |          |          |
| Total nonaccrual loans                                  | \$11,230 | \$13,404 | \$8,736            | \$11,517 | \$12,610 | \$14,934 |
| Total loans past due 90 days or more and still accruing | 3,195    | 3,724    | 6,838              | 3,229    | 2,843    | 3,131    |
| Total nonperforming loans                               | 14,425   | 17,128   | 15,574             | 14,746   | 15,453   | 18,065   |
| Foreclosed assets held for sale (real estate)           | 2,897    | 1,598    | 2,180              | 1,260    | 1,189    | 892      |
| Total nonperforming assets                              | \$17,322 | \$18,726 | \$17,754           | \$16,006 | \$16,642 | \$18,957 |
| Loans subject to troubled debt restructurings (TDRs):   |          |          |                    |          |          |          |
| Performing  | \$753    | \$636    | \$5,803            | \$1,186  | \$1,807  | \$3,267  |
| Nonperforming   | 2,951    | 3,027    | 2,874              | 5,178    | 5,388    | 908      |
| Total TDRs  | \$3,704  | \$3,663  | \$8,677            | \$6,364  | \$7,195  | \$4,175  |
| Total nonperforming loans as a % of loans               | 1.76 %   | 2.10 %   | 2.07 %             | 2.09 %   | 2.45 %   | 2.80 %   |
| Total nonperforming assets as a % of assets             | 1.35 %   | 1.47 %   | 1.43 %             | 1.31 %   | 1.34 %   | 1.53 %   |
| Allowance for loan losses as a % of total loans         | 1.08 %   | 1.09 %   | 1.13 %             | 1.12 %   | 1.16 %   | 1.34 %   |
| Allowance for loan losses as a % of nonperforming loans | 61.22 %  | 51.70 %  | 54.40 %            | 53.50 %  | 47.47 %  | 47.95 %  |

**TABLE XII - SUMMARY OF LOANS BY TYPE**

## Summary of Loans by Type

(In Thousands)

|   | June 30,  |           | As of December 31, |           |           |           |
|---|-----------|-----------|--------------------|-----------|-----------|-----------|
|   | 2018      | 2017      | 2016               | 2015      | 2014      | 2013      |
| Residential mortgage:                     |           |           |                    |           |           |           |
| Residential mortgage loans - first liens  | \$361,592 | \$359,987 | \$334,102          | \$304,783 | \$291,882 | \$299,831 |
| Residential mortgage loans - junior liens | 26,594    | 25,325    | 23,706             | 21,146    | 21,166    | 23,040    |
| Home equity lines of credit               | 34,852    | 35,758    | 38,057             | 39,040    | 36,629    | 34,530    |
| 1-4 Family residential construction       | 26,722    | 26,216    | 24,908             | 21,121    | 16,739    | 13,909    |
| Total residential mortgage                | 449,760   | 447,286   | 420,773            | 386,090   | 366,416   | 371,310   |
| Commercial:                               |           |           |                    |           |           |           |
| Commercial loans secured by real estate   | 159,392   | 159,266   | 150,468            | 154,779   | 145,878   | 147,215   |

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|                                      |           |           |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Commercial and industrial            | 88,499    | 88,276    | 83,854    | 75,196    | 50,157    | 42,387    |
| Political subdivisions               | 56,690    | 59,287    | 38,068    | 40,007    | 17,534    | 16,291    |
| Commercial construction and land     | 13,066    | 14,527    | 14,287    | 5,122     | 6,938     | 17,003    |
| Loans secured by farmland            | 7,397     | 7,255     | 7,294     | 7,019     | 7,916     | 10,468    |
| Multi-family (5 or more) residential | 7,860     | 7,713     | 7,896     | 9,188     | 8,917     | 10,985    |
| Agricultural loans                   | 5,622     | 6,178     | 3,998     | 4,671     | 3,221     | 3,251     |
| Other commercial loans               | 14,455    | 10,986    | 11,475    | 12,152    | 13,334    | 14,631    |
| Total commercial                     | 352,981   | 353,488   | 317,340   | 308,134   | 253,895   | 262,231   |
| Consumer                             | 15,906    | 14,939    | 13,722    | 10,656    | 10,234    | 10,762    |
| Total                                | 818,647   | 815,713   | 751,835   | 704,880   | 630,545   | 644,303   |
| Less: allowance for loan losses      | (8,831 )  | (8,856 )  | (8,473 )  | (7,889 )  | (7,336 )  | (8,663 )  |
| Loans, net                           | \$809,816 | \$806,857 | \$743,362 | \$696,991 | \$623,209 | \$635,640 |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****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 June 30, 2018, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$28,985,000.

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 \$15,481,000 at June 30, 2018.

The Corporation's outstanding, available, and total credit facilities at June 30, 2018 and December 31, 2017 are as follows:

| (In Thousands)                       | Outstanding   |               | Available     |               | Total Credit  |               |
|--------------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
|                                      | June 30, 2018 | Dec. 31, 2017 | June 30, 2018 | Dec. 31, 2017 | June 30, 2018 | Dec. 31, 2017 |
| Federal Home Loan Bank of Pittsburgh | \$39,054      | \$67,189      | \$324,880     | \$295,441     | \$363,934     | \$362,630     |
| Federal Reserve Bank Discount Window | 0             | 0             | 15,079        | 15,877        | 15,079        | 15,877        |
| Other correspondent banks            | 0             | 0             | 45,000        | 45,000        | 45,000        | 45,000        |
| Total credit facilities              | \$39,054      | \$67,189      | \$384,959     | \$356,318     | \$424,013     | \$423,507     |

At June 30, 2018, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of short-term borrowings of \$12,000,000 and long-term borrowings of \$27,054,000. At December 31, 2017, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of overnight borrowings of \$29,000,000, short-term borrowings of \$29,000,000 and long-term borrowings of \$9,189,000. Additional information regarding borrowed funds is included in Note 8 to the unaudited consolidated financial statements.

Additionally, the Corporation uses “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 or use repurchase agreements placed with brokers to borrow funds secured by investment assets. At June 30, 2018, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was \$172,786,000.

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 June 30, 2018 and December 31, 2017 are presented below. Management believes, as of June 30, 2018 and December 31, 2017, 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 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 June 30, 2018 and December 31, 2017 exceed the Corporation's policy threshold levels.

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| (Dollars in Thousands)                                |           | Minimum Capital Requirement |          |                          |          | Minimum To Maintain Capital Conservation Buffer at Reporting Date |          | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |          | Minimum To Meet the Corporation's Policy Thresholds |  |
|---|-----------|-----------------------------|----------|--------------------------|----------|---|----------|--|----------|---|--|
| Actual  |           | Requirement                 |          | Buffer at Reporting Date |          | Action Provisions   |          | Policy Thresholds  |          |   |  |
| Amount  | Ratio     | Amount                      | Ratio    | Amount                   | Ratio    | Amount  | Ratio    | Amount   | Ratio    |   |  |
| June 30, 2018:  |           |                             |          |                          |          |   |          |  |          |   |  |
| Total capital to risk-weighted assets:                |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | \$192,699 | 23.82%                      | \$64,705 | 38%                      | \$79,870 | 39.875%   | \$80,881 | 310%   | \$84,925 | 310.5%  |  |
| C&N Bank  | 170,389   | 21.18%                      | 64,358   | 38%                      | 79,442   | 39.875%   | 80,447   | 310%   | 84,470   | 310.5%  |  |
| Tier 1 capital to risk-weighted assets:               |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | 183,568   | 22.70%                      | 48,529   | 36%                      | 63,694   | 37.875%   | 64,705   | 38%  | 68,749   | 38.5%   |  |
| C&N Bank  | 161,258   | 20.05%                      | 48,268   | 36%                      | 63,352   | 37.875%   | 64,358   | 38%  | 68,380   | 38.5%   |  |
| Common equity tier 1 capital to risk-weighted assets: |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | 183,568   | 22.70%                      | 36,397   | 34.5%                    | 51,562   | 36.375%   | 52,573   | 36.5%  | 56,617   | 37%   |  |
| C&N Bank  | 161,258   | 20.05%                      | 36,201   | 34.5%                    | 51,285   | 36.375%   | 52,291   | 36.5%  | 56,313   | 37%   |  |
| Tier 1 capital to average assets:                     |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | 183,568   | 14.52%                      | 50,582   | 34%                      | N/A      | N/A   | 63,227   | 35%  | 63,227   | 35%   |  |
| C&N Bank  | 161,258   | 12.90%                      | 49,993   | 34%                      | N/A      | N/A   | 62,491   | 35%  | 62,491   | 35%   |  |
| December 31, 2017:                                    |           |                             |          |                          |          |   |          |  |          |   |  |
| Total capital to risk-weighted assets:                |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | \$187,097 | 23.07%                      | \$64,872 | 38%                      | \$75,008 | 39.25%  | \$81,090 | 310%   | \$85,144 | 310.5%  |  |
| C&N Bank  | 165,142   | 20.47%                      | 64,528   | 38%                      | 74,611   | 39.25%  | 80,661   | 310%   | 84,694   | 310.5%  |  |
| Tier 1 capital to risk-weighted assets:               |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | 177,981   | 21.95%                      | 48,654   | 36%                      | 58,790   | 37.25%  | 64,872   | 38%  | 68,926   | 38.5%   |  |
| C&N Bank  | 156,026   | 19.34%                      | 48,396   | 36%                      | 58,479   | 37.25%  | 64,528   | 38%  | 68,561   | 38.5%   |  |
| Common equity tier 1 capital to risk-weighted assets: |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | 177,981   | 21.95%                      | 36,490   | 34.5%                    | 46,626   | 35.75%  | 52,708   | 36.5%  | 56,763   | 37%   |  |
| C&N Bank  | 156,026   | 19.34%                      | 36,297   | 34.5%                    | 46,380   | 35.75%  | 52,429   | 36.5%  | 56,462   | 37%   |  |
| Tier 1 capital to average assets:                     |           |                             |          |                          |          |   |          |  |          |   |  |
| Consolidated  | 177,981   | 14.23%                      | 50,023   | 34%                      | N/A      | N/A   | 62,529   | 35%  | 62,529   | 35%   |  |
| C&N Bank  | 156,026   | 12.63%                      | 49,418   | 34%                      | N/A      | N/A   | 61,772   | 35%  | 61,772   | 35%   |  |

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 below, 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.

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.



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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. The current and remaining transition schedule for capital ratios, including the capital conservation buffer, is as follows:

|   | As of January 1: |        |
|---|------------------|--------|
|   | 2018             | 2019   |
| Minimum common equity tier 1 capital ratio                                  | 4.5 %            | 4.5 %  |
| Common equity tier 1 capital conservation buffer                            | 1.875 %          | 2.5 %  |
| Minimum common equity tier 1 capital ratio plus capital conservation buffer | 6.375 %          | 7.0 %  |
| Phase-in of most deductions from common equity tier 1 capital               | 100 %            | 100 %  |
| Minimum tier 1 capital ratio  | 6.0 %            | 6.0 %  |
| Minimum tier 1 capital ratio plus capital conservation buffer               | 7.875 %          | 8.5 %  |
| Minimum total capital ratio   | 8.0 %            | 8.0 %  |
| Minimum total capital ratio plus capital conservation buffer                | 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:

| <b>Capital Conservation Buffer<br/>(as a % of risk-weighted assets)</b> | <b>Maximum Payout<br/>(as a % of eligible retained income)</b> |
|---|--|
| 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 June 30, 2018, the Corporation's Capital Conservation Buffer, determined based on the minimum total capital ratio, was 15.82%. C&N Bank's Capital Conservation Buffer (also determined based on the minimum total capital ratio) was 13.18%.

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 debt securities, net of deferred income tax, is included in Accumulated Other Comprehensive Income (Loss) within stockholders' equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains (losses) on available-for-sale securities, net of deferred income tax, amounted to (\$6,476,000) at June 30, 2018 and (\$1,566,000) at December 31, 2017. Changes in accumulated other comprehensive income (loss) 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 June 30, 2018.

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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 (Loss) related to defined benefit plans, net of deferred income tax, was \$137,000 at June 30, 2018 and \$59,000 at December 31, 2017.

### **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 \$5,570,000 for the three months ended June 30, 2018 as compared to \$5,116,000 in the second quarter 2017. For the three months ended June 30, 2018, Comprehensive Income included: (1) Net Income of \$6,371,000, which was \$2,250,000 higher than in the second quarter 2017; (2) Other Comprehensive Loss from a decrease in net unrealized losses on available-for-sale securities of (\$797,000) as compared to Other Comprehensive Income of \$999,000 from net unrealized gains on available-for-sale securities in the second quarter 2017; and (3) Other Comprehensive Loss from defined benefit plans of (\$4,000) for the second quarter 2018 and for the second quarter 2017.

For the six months ended June 30, 2018, Comprehensive Income totaled \$6,191,000 as compared to \$8,973,000 for the first six months of 2017. For the six months ended June 30, 2018, Comprehensive Income included: (1) Net Income of \$10,746,000, up \$3,191,000 from net income for the first six months of 2017; (2) Other Comprehensive Loss from a decrease in net unrealized losses on available-for-sale securities of (\$4,621,000) as compared to Other Comprehensive Income of \$1,318,000 from net unrealized gains on available-for-sale securities in the first six months of 2017; and (3) Other Comprehensive Income from defined benefit plans of \$66,000 for the six months ended June 30, 2018 as compared to Other Comprehensive Income of \$100,000 for the first six months of 2017.

### **INFLATION**

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in short-term interest rates. Since September 2007, the Federal Reserve has maintained the fed funds target rate at extremely low levels by historical standards. Further, throughout the period of low interest rates, the Federal Reserve has injected massive amounts of liquidity into the nation's monetary system through a variety of programs. Since late

2015, the Federal Reserve has begun to move its fed funds target rate higher, in an effort to re-establish a more normalized level by historical standards, with seven separate 0.25% increases from December 2015 through June 2018, resulting in the current range of 1.75% to 2.00%. Inflation has remained subdued, measured through 2017 and the first six months of 2018 at levels at or below the Federal Open Market Committee's 2% longer run objective. The FOMC noted in its latest statement that the labor market continues to strengthen and that economic activity continues to rise at a solid rate with household spending picking up and business fixed investment growing. The Committee continues to suggest that as market conditions continue to improve, further gradual increases in the federal funds rate will be warranted.

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.

## **RECENT LEGISLATIVE DEVELOPMENTS**

On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"), which was designed to ease certain restrictions imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Most of the changes made by the new Act can be grouped into five general areas: mortgage lending; certain regulatory relief for "community" banks; enhanced consumer protections in specific areas, including subjecting credit reporting agencies to additional requirements; certain regulatory relief for large financial institutions, including increasing the threshold at which institutions are classified as systemically important financial institutions (from \$50 billion to \$250 billion) and therefore subject to stricter oversight, and revising the rules for larger institution stress testing; and certain changes to federal securities regulations designed to promote capital formation. Some of the key provisions of the Act as it relates to community banks and bank holding companies include, but are not limited to: (i) designating mortgages held in portfolio as "qualified mortgages" for banks with less than \$10 billion in assets, subject to certain documentation and product limitations; (ii) exempting banks with less than \$10 billion in assets from Volcker Rule requirements relating to proprietary trading; (iii) simplifying capital calculations for banks with less than \$10 billion in assets by requiring federal banking agencies to establish a community bank leverage ratio of tangible equity to average consolidated assets of not less than 8% or more than 10%, and provide that banks that maintain tangible equity in excess of such ratio will be deemed to be in compliance with risk-based capital and leverage requirements; (iv) assisting smaller banks with obtaining stable funding by providing an exception for reciprocal deposits from FDIC restrictions on acceptance of brokered deposits; (v) raising the eligibility for use of short-form Call Reports from \$1 billion to \$5 billion in assets; and (vi) clarifying definitions pertaining to high volatility commercial real estate loans (HVCRE), which require higher capital allocations, so that only loans with increased risk are subject to higher risk weightings. The Corporation continues to analyze the changes implemented by the Act, but does not believe that such changes will materially impact the Corporation's business, operations, or financial results.

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**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 major category of market risk, interest rate risk, is discussed in the following section.

**INTEREST RATE RISK**

Business risk arising from changes in interest rates is an inherent factor in operating a bank. A significant portion of the Corporation's assets are 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 June 30, 2018 and December 31, 2017. 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.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE XIII - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES**

June 30, 2018 Data

(Dollars In Thousands) Period Ending June 30, 2019

| Basis Point<br>Change in Rates | Interest<br>Income | Interest<br>Expense | Net Interest<br>Income (NII) | NII<br>% Change | NII<br>Risk Limit |      |   |
|--------------------------------|--------------------|---------------------|------------------------------|-----------------|-------------------|------|---|
| +400                           | \$60,391           | \$19,673            | \$ 40,718                    | -8.8            | %                 | 25.0 | % |
| +300                           | 57,690             | 15,948              | 41,742                       | -6.5            | %                 | 20.0 | % |
| +200                           | 55,020             | 12,222              | 42,798                       | -4.1            | %                 | 15.0 | % |
| +100                           | 52,271             | 8,497               | 43,774                       | -1.9            | %                 | 10.0 | % |
| 0                              | 49,417             | 4,778               | 44,639                       | 0.0             | %                 | 0.0  | % |
| -100                           | 46,175             | 3,123               | 43,052                       | -3.6            | %                 | 10.0 | % |
| -200                           | 43,160             | 2,627               | 40,533                       | -9.2            | %                 | 15.0 | % |
| -300                           | 41,520             | 2,439               | 39,081                       | -12.5           | %                 | 20.0 | % |
| -400                           | 41,237             | 2,439               | 38,798                       | -13.1           | %                 | 25.0 | % |

Market Value of Portfolio Equity at June 30, 2018

| Basis Point<br>Change in Rates | Present<br>Value<br>Equity | Present<br>Value<br>% Change | Present<br>Value<br>Risk Limit |      |   |
|--------------------------------|----------------------------|------------------------------|--------------------------------|------|---|
| +400                           | \$ 200,729                 | -15.8                        | %                              | 40.0 | % |
| +300                           | 208,792                    | -12.5                        | %                              | 30.0 | % |
| +200                           | 219,045                    | -8.2                         | %                              | 25.0 | % |
| +100                           | 228,463                    | -4.2                         | %                              | 15.0 | % |
| 0                              | 238,490                    | 0.0                          | %                              | 0.0  | % |
| -100                           | 240,239                    | 0.7                          | %                              | 15.0 | % |
| -200                           | 238,693                    | 0.1                          | %                              | 25.0 | % |
| -300                           | 239,087                    | 0.3                          | %                              | 30.0 | % |
| -400                           | 275,020                    | 15.3                         | %                              | 40.0 | % |

December 31, 2017 Data

(Dollars in Thousands)

Period Ending December 31, 2018

| Basis Point<br>Change in Rates | Interest<br>Income | Interest<br>Expense | Net Interest<br>Income (NII) | NII<br>% Change | NII<br>Risk Limit |      |   |
|--------------------------------|--------------------|---------------------|------------------------------|-----------------|-------------------|------|---|
| +400                           | \$57,619           | \$ 19,730           | \$ 37,889                    | -10.8           | %                 | 25.0 | % |
| +300                           | 54,978             | 15,852              | 39,126                       | -7.9            | %                 | 20.0 | % |
| +200                           | 52,334             | 11,974              | 40,360                       | -5.0            | %                 | 15.0 | % |
| +100                           | 49,620             | 8,095               | 41,525                       | -2.2            | %                 | 10.0 | % |
| 0                              | 46,717             | 4,243               | 42,474                       | 0.0             | %                 | 0.0  | % |
| -100                           | 43,581             | 2,781               | 40,800                       | -3.9            | %                 | 10.0 | % |

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|      |        |       |        |       |   |      |   |
|------|--------|-------|--------|-------|---|------|---|
| -200 | 41,290 | 2,216 | 39,074 | -8.0  | % | 15.0 | % |
| -300 | 40,463 | 2,191 | 38,272 | -9.9  | % | 20.0 | % |
| -400 | 40,194 | 2,191 | 38,003 | -10.5 | % | 25.0 | % |

Market Value of Portfolio Equity at December 31, 2017

| Basis Point<br>Change in Rates | <b>Present<br/>Value<br/>Equity</b> | <b>Present<br/>Value<br/>% Change</b> |   | <b>Present<br/>Value<br/>Risk Limit</b> |   |
|--------------------------------|-------------------------------------|---------------------------------------|---|---|---|
| +400                           | \$ 195,385                          | -16.8                                 | % | 40.0                                    | % |
| +300                           | 203,648                             | -13.3                                 | % | 30.0                                    | % |
| +200                           | 213,689                             | -9.0                                  | % | 25.0                                    | % |
| +100                           | 224,389                             | -4.4                                  | % | 15.0                                    | % |
| 0                              | 234,759                             | 0.0                                   | % | 0.0                                     | % |
| -100                           | 236,030                             | 0.5                                   | % | 15.0                                    | % |
| -200                           | 234,863                             | 0.0                                   | % | 25.0                                    | % |
| -300                           | 252,464                             | 7.5                                   | % | 30.0                                    | % |
| -400                           | 292,124                             | 24.4                                  | % | 40.0                                    | % |



**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

**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.

During the quarter ended June 30, 2018, the Corporation completed the implementation of a new loan origination system for residential mortgages and consumer loans and revised certain loan processing procedures for residential mortgages, consumer loans and commercial loans. These changes included restructuring of the loan processing department and reassignment of responsibilities within that department. Management's internal control oversight and assessment include consideration of these changes. Except as previously described, 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.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

## 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 15, 2018.

## 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 second quarter 2018:

| 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 |
|--------------------|----------------------------------|------------------------------|--|--|
| April 1 - 30, 2018 | 0                                | \$ 0                         | 0  | 600,000  |
| May 1 - 31, 2018   | 0                                | \$ 0                         | 0  | 600,000  |
| June 1 - 30, 2018  | 0                                | \$ 0                         | 0  | 600,000  |

Note to Table: Effective April 21, 2016, the Corporation's Board of Directors approved a treasury stock repurchase program. Under this 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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

**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:

10.1 Form of Indemnification Agreements dated May 24, 2018 between the Corporation and Directors Bobbi J. Kilmer, Terry L. Lehman, Frank G. Pellegrino and Aaron K. Singer

Filed herewith

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

|  | <u>statements, which is included in Part I, Item 1 of Form 10-Q</u> |
|--|---|
| 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:                                 |   |
| <u>31.1 Certification of Chief Executive Officer</u>                         | <u>Filed herewith</u>   |
| <u>31.2 Certification of Chief Financial Officer</u>                         | <u>Filed herewith</u>   |
| <u>32. Section 1350 certifications</u>                                       | <u>Filed herewith</u>   |
| 99. Additional exhibits  | Not applicable  |
| 100. XBRL-related documents  | Not applicable  |
| 101. Interactive data file   | Filed herewith  |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q**

**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

August 6, 2018 By: /s/ J. Bradley Scovill

Date President and Chief Executive Officer

August 6, 2018 By: /s/ Mark A. Hughes

Date Treasurer and Chief Financial Officer