

CITIZENS & NORTHERN CORP  
Form 10-Q  
November 07, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

or

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

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

Commission file number: 000-16084

**CITIZENS & NORTHERN CORPORATION**

(Exact name of Registrant as specified in its charter)

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

90-92 MAIN STREET, WELLSBORO, PA 16901

(Address of principal executive offices) (Zip code)

570-724-3411

(Registrant's telephone number including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

Common Stock (\$1.00 par value) 12,292,607 Shares Outstanding on November 3, 2014

**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)

|  | Sept. 30,<br>2014  | December 31,<br>2013 |
|--|--------------------|----------------------|
| <b>ASSETS</b>  |                    |                      |
| Cash and due from banks:   |                    |                      |
| Noninterest-bearing  | \$17,743           | \$15,917             |
| Interest-bearing   | 37,696             | 28,702               |
| Total cash and due from banks  | 55,439             | 44,619               |
| Available-for-sale securities, at fair value   | 508,253            | 482,658              |
| Loans held for sale  | 418                | 54                   |
| <br>   |                    |                      |
| Loans receivable   | 629,409            | 644,303              |
| Allowance for loan losses  | (7,449)            | (8,663)              |
| Loans, net   | 621,960            | 635,640              |
| Bank-owned life insurance  | 22,021             | 21,743               |
| Accrued interest receivable  | 3,964              | 4,146                |
| Bank premises and equipment, net   | 16,402             | 17,430               |
| Foreclosed assets held for sale  | 1,888              | 892                  |
| Deferred tax asset, net  | 2,673              | 6,344                |
| Intangible asset - Core deposit intangibles  | 61                 | 87                   |
| Intangible asset - Goodwill  | 11,942             | 11,942               |
| Other assets   | 11,512             | 12,140               |
| <b>TOTAL ASSETS</b>  | <b>\$1,256,533</b> | <b>\$1,237,695</b>   |
| <br>   |                    |                      |
| <b>LIABILITIES</b>   |                    |                      |
| Deposits:  |                    |                      |
| Noninterest-bearing  | \$209,357          | \$191,245            |
| Interest-bearing   | 772,172            | 763,271              |
| Total deposits   | 981,529            | 954,516              |
| Short-term borrowings  | 6,765              | 23,385               |
| Long-term borrowings   | 73,131             | 73,338               |
| Accrued interest and other liabilities   | 8,234              | 6,984                |
| <b>TOTAL LIABILITIES</b>   | <b>1,069,659</b>   | <b>1,058,223</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 at September 30, 2014 and December 31, 2013 | 0                  | 0                    |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2014 and 2013; issued 12,655,171 at September 30, 2014 and 12,596,540 at December 31, 2013 | 12,655             | 12,596               |
| Paid-in capital  | 71,442             | 70,105               |
| Retained earnings  | 104,344            | 101,216              |
| Treasury stock, at cost; 316,051 shares at September 30, 2014 and 206,477 shares at December 31, 2013  | (5,604)            | (3,452)              |
| Sub-total  | 182,837            | 180,465              |
| Accumulated other comprehensive income (loss):   |                    |                      |
| Unrealized gain (loss) on available-for-sale securities  | 3,940              | (1,004)              |
| Defined benefit plans gain   | 97                 | 11                   |

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|   |             |             |
|---|-------------|-------------|
| Total accumulated other comprehensive income (loss) | 4,037       | (993)       |
| TOTAL STOCKHOLDERS' EQUITY                          | 186,874     | 179,472     |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY            | \$1,256,533 | \$1,237,695 |

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

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

| Consolidated Statements of Income<br><br>(In Thousands Except Per Share Data) (Unaudited) | 3 Months Ended |                | Fiscal Year To Date      |          |
|---|----------------|----------------|--------------------------|----------|
|   | Sept. 30, 2014 | Sept. 30, 2013 | 9 Months Ended Sept. 30, |          |
|   | 2014           | 2013           | 2014                     | 2013     |
| <b>INTEREST INCOME</b>  |                |                |                          |          |
| Interest and fees on loans  | \$8,040        | \$8,742        | \$24,123                 | \$26,995 |
| Interest on balances with depository institutions   | 33             | 25             | 95                       | 76       |
| Interest on loans to political subdivisions   | 348            | 337            | 1,055                    | 1,022    |
| Interest on mortgages held for sale   | 5              | 14             | 13                       | 47       |
| Income from available-for-sale securities:  |                |                |                          |          |
| Taxable   | 1,990          | 1,640          | 5,753                    | 5,020    |
| Tax-exempt  | 1,070          | 1,185          | 3,261                    | 3,640    |
| Dividends   | 86             | 84             | 241                      | 229      |
| Total interest and dividend income  | 11,572         | 12,027         | 34,541                   | 37,029   |
| <b>INTEREST EXPENSE</b>   |                |                |                          |          |
| Interest on deposits  | 543            | 647            | 1,650                    | 2,098    |
| Interest on short-term borrowings   | 1              | 3              | 7                        | 6        |
| Interest on long-term borrowings  | 743            | 746            | 2,208                    | 2,307    |
| Total interest expense  | 1,287          | 1,396          | 3,865                    | 4,411    |
| Net interest income   | 10,285         | 10,631         | 30,676                   | 32,618   |
| Provision for loan losses   | 218            | 239            | 353                      | 488      |
| Net interest income after provision for loan losses                                       | 10,067         | 10,392         | 30,323                   | 32,130   |
| <b>OTHER INCOME</b>   |                |                |                          |          |
| Service charges on deposit accounts   | 1,275          | 1,357          | 3,812                    | 3,825    |
| Service charges and fees  | 144            | 165            | 405                      | 444      |
| Trust and financial management revenue  | 1,140          | 1,033          | 3,325                    | 3,022    |
| Brokerage revenue   | 213            | 205            | 682                      | 586      |
| Insurance commissions, fees and premiums  | 44             | 32             | 103                      | 136      |
| Interchange revenue from debit card transactions  | 504            | 484            | 1,474                    | 1,453    |
| Net gains from sale of loans  | 141            | 504            | 557                      | 1,560    |
| (Decrease) increase in fair value of servicing rights                                     | (17)           | 79             | 35                       | 84       |
| Increase in cash surrender value of life insurance  | 99             | 109            | 278                      | 301      |
| Net gain from premises and equipment  | 9              | 14             | 8                        | 14       |
| Other operating income  | 335            | 311            | 939                      | 902      |
| Sub-total   | 3,887          | 4,293          | 11,618                   | 12,327   |
| Total other-than-temporary impairment losses on available-for-sale securities             | 0              | 0              | 0                        | (25)     |
| Portion of (gain) recognized in other comprehensive loss (before taxes)                   | 0              | 0              | 0                        | 0        |
| Net impairment losses recognized in earnings  | 0              | 0              | 0                        | (25)     |
| Realized gains on available-for-sale securities, net                                      | 760            | 193            | 894                      | 1,477    |
| Total other income  | 4,647          | 4,486          | 12,512                   | 13,779   |
| <b>OTHER EXPENSES</b>   |                |                |                          |          |
| Salaries and wages  | 4,348          | 3,536          | 11,559                   | 10,771   |
| Pensions and other employee benefits  | 1,091          | 876            | 3,563                    | 3,165    |
| Occupancy expense, net  | 646            | 626            | 2,002                    | 1,859    |
| Furniture and equipment expense   | 461            | 487            | 1,399                    | 1,464    |

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|  |         |         |          |          |
|--|---------|---------|----------|----------|
| FDIC Assessments                                 | 151     | 151     | 444      | 450      |
| Pennsylvania shares tax                          | 336     | 350     | 1,014    | 1,051    |
| Professional fees                                | 135     | 806     | 427      | 1,424    |
| Automated teller machine and interchange expense | 239     | 218     | 668      | 802      |
| Software subscriptions                           | 184     | 209     | 575      | 641      |
| Loss on prepayment of debt                       | 0       | 0       | 0        | 1,023    |
| Other operating expense                          | 1,445   | 1,351   | 4,256    | 4,056    |
| Total other expenses                             | 9,036   | 8,610   | 25,907   | 26,706   |
| Income before income tax provision               | 5,678   | 6,268   | 16,928   | 19,203   |
| Income tax provision                             | 1,411   | 1,579   | 4,210    | 4,834    |
| NET INCOME                                       | \$4,267 | \$4,689 | \$12,718 | \$14,369 |
| NET INCOME PER SHARE - BASIC                     | \$0.34  | \$0.38  | \$1.02   | \$1.16   |
| NET INCOME PER SHARE - DILUTED                   | \$0.34  | \$0.38  | \$1.02   | \$1.16   |

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<br>Ended<br>Sept. 30, |         | Nine Months<br>Ended<br>Sept. 30, |          |
|--|------------------------------------|---------|-----------------------------------|----------|
|  | 2014                               | 2013    | 2014                              | 2013     |
| Net income   | \$4,267                            | \$4,689 | \$12,718                          | \$14,369 |
| Unrealized (losses) gains on available-for-sale securities:  |                                    |         |                                   |          |
| Unrealized holding (losses) gains on available-for-sale securities   | (1,357)                            | (286)   | 8,500                             | (12,465) |
| Reclassification adjustment for gains realized in income   | (760)                              | (193)   | (894)                             | (1,452)  |
| Other comprehensive (loss) gain on available-for-sale securities   | (2,117)                            | (479)   | 7,606                             | (13,917) |
| Unfunded pension and postretirement obligations:   |                                    |         |                                   |          |
| Changes from plan amendments and actuarial gains and losses included in accumulated other comprehensive gain               | 0                                  | 0       | 144                               | 636      |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (4)                                | 0       | (12)                              | 0        |
| Other comprehensive (loss) gain on unfunded retirement obligations   | (4)                                | 0       | 132                               | 636      |
| Other comprehensive (loss) income before income tax  | (2,121)                            | (479)   | 7,738                             | (13,281) |
| Income tax related to other comprehensive loss (income)  | 742                                | 167     | (2,708)                           | 4,646    |
| Net other comprehensive (loss) income  | (1,379)                            | (312)   | 5,030                             | (8,635)  |
| Comprehensive income   | \$2,888                            | \$4,377 | \$17,748                          | \$5,734  |

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

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

| CONSOLIDATED<br>STATEMENTS OF CASH<br>FLOWS<br>(In Thousands) (Unaudited)               | Nine Months Ended Sept. 30, |          |
|---|-----------------------------|----------|
|   | 2014                        | 2013     |
| <b>CASH FLOWS FROM<br/>OPERATING ACTIVITIES:</b>  |                             |          |
| Net income  | \$12,718                    | \$14,369 |
| Adjustments to reconcile net<br>income to net cash provided by<br>operating activities: |                             |          |
| Provision for loan losses   | 353                         | 488      |
| Realized gains on<br>available-for-sale securities, net                                 | (894)                       | (1,452)  |
| Loss on prepayment of debt  | 0                           | 1,023    |
| Realized loss on foreclosed<br>assets   | 49                          | 71       |
| Gain on disposition of<br>premises and equipment  | (8)                         | (14)     |
| Depreciation expense  | 1,470                       | 1,523    |
| Accretion and amortization<br>on securities, net  | 1,008                       | 1,428    |
| Accretion and amortization<br>on loans and deposits, net                                | (20)                        | (25)     |
| Increase in fair value of<br>servicing rights   | (35)                        | (84)     |
| Increase in cash surrender<br>value of life insurance                                   | (278)                       | (301)    |
| Stock-based compensation  | 463                         | 605      |
| Amortization of core deposit<br>intangibles   | 26                          | 38       |
| Deferred income taxes   | 963                         | 1,864    |
| Gains on sales of loans, net  | (557)                       | (1,560)  |
| Origination of loans for sale   | (16,544)                    | (47,737) |
| Proceeds from sales of loans  | 16,599                      | 50,681   |
| Decrease in accrued interest<br>receivable and other assets                             | 126                         | 3,410    |
| Increase in accrued interest<br>payable and other liabilities                           | 1,028                       | 2,107    |
| Net Cash Provided by<br>Operating Activities  | 16,467                      | 26,434   |
| <b>CASH FLOWS FROM<br/>INVESTING ACTIVITIES:</b>  |                             |          |
| Proceeds from maturities of<br>certificates of deposit                                  | 720                         | 240      |
| Purchase of certificates of<br>deposit  | 0                           | (960)    |

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|   |                 |                 |
|---|-----------------|-----------------|
| Proceeds from sales of available-for-sale securities                | 52,344          | 24,120          |
| Proceeds from calls and maturities of available-for-sale securities | 56,581          | 77,222          |
| Purchase of available-for-sale securities                           | (126,674)       | (118,308)       |
| Redemption of Federal Home Loan Bank of Pittsburgh stock            | 977             | 2,678           |
| Purchase of Federal Home Loan Bank of Pittsburgh stock              | (245)           | (825)           |
| Net decrease in loans   | 11,833          | 35,022          |
| Purchase of premises and equipment                                  | (477)           | (484)           |
| Proceeds from disposition of premises and equipment                 | 43              | 42              |
| Purchase of investment in limited liability entity                  | 0               | (147)           |
| Return of principal on limited liability entity investments         | 125             | 126             |
| Proceeds from sale of foreclosed assets                             | 469             | 255             |
| Net Cash (Used in) Provided by Investing Activities                 | (4,304)         | 18,981          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                        |                 |                 |
| Net increase (decrease) in deposits                                 | 27,013          | (42,641)        |
| Net decrease in short-term borrowings                               | (16,620)        | (734)           |
| Repayments of long-term borrowings                                  | (207)           | (11,430)        |
| Purchase of treasury stock  | (2,464)         | 0               |
| Sale of treasury stock  | 99              | 168             |
| Tax benefit from compensation plans                                 | 120             | 91              |
| Common dividends paid   | (8,564)         | (8,178)         |
| Net Cash Used in Financing Activities                               | (623)           | (62,724)        |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>             | <b>11,540</b>   | <b>(17,309)</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>                 | <b>38,591</b>   | <b>55,016</b>   |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                     | <b>\$50,131</b> | <b>\$37,707</b> |

SUPPLEMENTAL  
DISCLOSURES OF CASH

FLOW INFORMATION:

|   |         |         |
|---|---------|---------|
| Assets acquired through<br>foreclosure of real estate loans | \$1,514 | \$223   |
| Accrued purchase of<br>available-for-sale securities        | \$354   | \$0     |
| Interest paid   | \$3,888 | \$4,437 |
| Income taxes paid   | \$3,062 | \$2,866 |

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

Nine Months Ended September 30, 2014 and 2013

(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 | Accum. Other<br>Comprehensive<br>(Loss)<br>Income | Treasury<br>Stock | Total     |
|--|------------------|--------------------|-----------------|--------------------|----------------------|---|-------------------|-----------|
| <b><u>Nine Months Ended September 30, 2014:</u></b>                              |                  |                    |                 |                    |                      |   |                   |           |
| Balance, December 31, 2013   | 12,596,540       | 206,477            | \$12,596        | \$70,105           | \$101,216            | (\$993)   | (\$3,452)         | \$179,000 |
| Net income   |                  |                    |                 |                    | 12,718               |   |                   | 12,718    |
| Other comprehensive income, net  |                  |                    |                 |                    |                      | 5,030   |                   | 5,030     |
| Cash dividends declared on common<br>stock, \$.78 per share                      |                  |                    |                 |                    | (9,693)              |   |                   | (9,693)   |
| Shares issued for dividend reinvestment<br>plan                                  | 59,498           |                    | 60              | 1,069              |                      |   |                   | 1,127     |
| Treasury stock purchased   |                  | 129,000            |                 |                    |                      |   | (2,464)           | (2,464)   |
| Shares issued from treasury and redeemed<br>related to exercise of stock options | (867)            | (10,173)           | (1)             | (58)               |                      |   | 158               | 99        |
| Restricted stock granted   |                  | (16,711)           |                 | (279)              |                      |   | 279               | 0         |
| Forfeiture of restricted stock   |                  | 7,458              |                 | 125                |                      |   | (125)             | 0         |
| Stock-based compensation expense   |                  |                    |                 | 463                |                      |   |                   | 463       |
| Tax effect of stock option exercises   |                  |                    |                 | 1                  |                      |   |                   | 1         |
| Tax benefit from dividends on restricted<br>stock                                |                  |                    |                 | 16                 |                      |   |                   | 16        |
| Tax benefit from employee benefit plan   |                  |                    |                 |                    | 103                  |   |                   | 103       |
| Balance, September 30, 2014  | 12,655,171       | 316,051            | \$12,655        | \$71,442           | \$104,344            | \$4,037   | (\$5,604)         | \$188,000 |
| <b><u>Nine Months Ended September 30, 2013:</u></b>                              |                  |                    |                 |                    |                      |   |                   |           |
| Balance, December 31, 2012   | 12,525,411       | 251,376            | \$12,525        | \$68,622           | \$94,839             | \$11,003  | (\$4,203)         | \$182,000 |
| Net income   |                  |                    |                 |                    | 14,369               |   |                   | 14,369    |
| Other comprehensive loss, net  |                  |                    |                 |                    |                      | (8,635)   |                   | (8,635)   |
| Cash dividends declared on common<br>stock, \$.75 per share                      |                  |                    |                 |                    | (9,250)              |   |                   | (9,250)   |
| Shares issued for dividend reinvestment<br>plan                                  | 53,794           |                    | 54              | 1,018              |                      |   |                   | 1,072     |
| Shares issued from treasury related to<br>exercise of stock options              |                  | (9,651)            |                 | 6                  |                      |   | 162               | 168       |
| Restricted stock granted   |                  | (37,886)           |                 | (633)              |                      |   | 633               | 0         |
| Forfeiture of restricted stock   |                  | 3,233              |                 | 54                 |                      |   | (54)              | 0         |
| Stock-based compensation expense   |                  |                    |                 | 605                |                      |   |                   | 605       |
| Tax effect of stock option exercises   |                  |                    |                 | (3)                |                      |   |                   | (3)       |
| Tax benefit from employee benefit plan   |                  |                    |                 |                    | 94                   |   |                   | 94        |
| Balance, September 30, 2013  | 12,579,205       | 207,072            | \$12,579        | \$69,669           | \$100,052            | \$2,368   | (\$3,462)         | \$182,000 |

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**

The consolidated financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2013, 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 2013 information has been reclassified for consistency with the 2014 presentation.

Operating results reported for the three-month and nine-month periods ended September 30, 2014 might not be indicative of the results for the year ending December 31, 2014. The Corporation evaluates subsequent events through the date of filing with the Securities and Exchange Commission.

**2. PER SHARE DATA**

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

|   | Net<br>Income | Weighted-<br>Average<br>Common<br>Shares | Earnings<br>Per<br>Share |
|---|---------------|--|--------------------------|
| Nine Months Ended September 30, 2014                                  |               |  |                          |
| Earnings per share – basic  | \$12,718,000  | 12,419,538                               | \$1.02                   |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 233,579                                  |                          |

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|   |              |            |        |  |
|---|--------------|------------|--------|--|
| Hypothetical share repurchase at \$19.28                              |              | (212,200)  |        |  |
| Earnings per share – diluted  | \$12,718,000 | 12,440,917 | \$1.02 |  |
| Nine Months Ended September 30, 2013                                  |              |            |        |  |
| Earnings per share – basic  | \$14,369,000 | 12,342,706 | \$1.16 |  |
| Dilutive effect of potential common stock arising from stock options: |              |            |        |  |
| Exercise of outstanding stock options                                 |              | 251,970    |        |  |
| Hypothetical share repurchase at \$19.73                              |              | (222,749)  |        |  |
| Earnings per share – diluted  | \$14,369,000 | 12,371,927 | \$1.16 |  |



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

|  | Net<br>Income | Weighted-<br>Average<br>Common<br>Shares | Earnings<br>Per<br>Share |
|--|---------------|--|--------------------------|
| Quarter Ended September 30, 2014   |               |  |                          |
| Earnings per share – basic   | \$4,267,000   | 12,399,482                               | \$0.34                   |
| Dilutive effect of potential common stock<br>arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                    |               | 222,344                                  |                          |
| Hypothetical share repurchase at \$19.33                                 |               | (201,826)                                |                          |
| Earnings per share – diluted   | \$4,267,000   | 12,420,000                               | \$0.34                   |
| Quarter Ended September 30, 2013   |               |  |                          |
| Earnings per share – basic   | \$4,689,000   | 12,363,887                               | \$0.38                   |
| Dilutive effect of potential common stock<br>arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                    |               | 302,956                                  |                          |
| Hypothetical share repurchase at \$20.10                                 |               | (269,941)                                |                          |
| Earnings per share – diluted   | \$4,689,000   | 12,396,902                               | \$0.38                   |

Stock options that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 169,728 shares in the nine-month period ended September 30, 2014, 98,809 shares in the nine-month period ended September 30, 2013, 137,873 shares in the third quarter 2014 and 57,658 shares in the third quarter 2013.

**3. COMPREHENSIVE INCOME**

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

| (In Thousands)  | Before-Tax<br>Amount | Income Tax<br>Effect | Net-of-Tax<br>Amount |
|---|----------------------|----------------------|----------------------|
| Nine Months Ended Sept. 30, 2014:                           |                      |                      |                      |
| Unrealized gains on available-for-sale securities:          |                      |                      |                      |
| Unrealized holding gains on available-for-sale securities   | \$8,500              | (\$2,975)            | \$5,525              |
| Reclassification adjustment for (gains) realized in income  | (894)                | 313                  | (581)                |
| Other comprehensive gain on available-for-sale securities   | 7,606                | (2,662)              | 4,944                |
| Unfunded pension and postretirement obligations:            |                      |                      |                      |
| Changes from plan amendments and actuarial gains and losses |                      |                      |                      |

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|  |         |           |         |
|--|---------|-----------|---------|
| included in other comprehensive income   | 144     | (50)      | 94      |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (12)    | 4         | (8)     |
| Other comprehensive gain on unfunded retirement obligations  | 132     | (46)      | 86      |
| Total other comprehensive gain   | \$7,738 | (\$2,708) | \$5,030 |

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

| (In Thousands)   | Before-Tax<br>Amount | Income Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|----------------------|----------------------|
| Nine Months Ended Sept. 30, 2013:  |                      |                      |                      |
| Unrealized gains on available-for-sale securities:   |                      |                      |                      |
| Unrealized holding losses on available-for-sale securities   | (\$12,465)           | \$4,362              | (\$8,103)            |
| Reclassification adjustment for (gains) realized in income   | (1,452)              | 507                  | (945)                |
| Other comprehensive loss on available-for-sale securities  | (13,917)             | 4,869                | (9,048)              |
| Unfunded pension and postretirement obligations:   |                      |                      |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         | 636                  | (223)                | 413                  |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 0                    | 0                    | 0                    |
| Other comprehensive gain on unfunded retirement obligations  | 636                  | (223)                | 413                  |
| Total other comprehensive loss   | (\$13,281)           | \$4,646              | (\$8,635)            |

| (In Thousands)   | Before-Tax<br>Amount | Income Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|----------------------|----------------------|
| Three Months Ended Sept. 30, 2014:   |                      |                      |                      |
| Unrealized gains on available-for-sale securities:   |                      |                      |                      |
| Unrealized holding losses on available-for-sale securities   | (\$1,357)            | \$475                | (\$882)              |
| Reclassification adjustment for (gains) realized in income   | (760)                | 266                  | (494)                |
| Other comprehensive loss on available-for-sale securities  | (2,117)              | 741                  | (1,376)              |
| Unfunded pension and postretirement obligations:   |                      |                      |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         | 0                    | 0                    | 0                    |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | (4)                  | 1                    | (3)                  |
| Other comprehensive loss on unfunded retirement obligations  | (4)                  | 1                    | (3)                  |
| Total other comprehensive loss   | (\$2,121)            | \$742                | (\$1,379)            |

| (In Thousands)   | Before-Tax<br>Amount | Income Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|----------------------|----------------------|
| Three Months Ended Sept. 30, 2013:   |                      |                      |                      |
| Unrealized gains on available-for-sale securities:   |                      |                      |                      |
| Unrealized holding losses on available-for-sale securities   | (\$286)              | \$101                | (\$185)              |
| Reclassification adjustment for (gains) realized in income   | (193)                | 66                   | (127)                |
| Other comprehensive loss on available-for-sale securities  | (479)                | 167                  | (312)                |
| Unfunded pension and postretirement obligations:   |                      |                      |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income | 0                    | 0                    | 0                    |

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|  |         |       |         |
|--|---------|-------|---------|
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 0       | 0     | 0       |
| Other comprehensive gain on unfunded retirement obligations  | 0       | 0     | 0       |
| Total other comprehensive loss   | (\$479) | \$167 | (\$312) |

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

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

| (In Thousands)  | Unrealized<br>Holding<br>Gains<br>(Losses)<br>on<br>Securities | Unfunded<br>Pension and<br>Postretirement<br>Obligations | Accumulated<br>Other<br>Comprehensive<br>Income |
|---|--|--|---|
| <b>Nine Months Ended September 30, 2014</b>                         |  |  |   |
| Balance, beginning of period  | (\$1,004)  | \$11   | (\$993)   |
| Other comprehensive income before reclassifications                 | 5,525  | 94   | 5,619   |
| Amounts reclassified from accumulated other<br>comprehensive income | (581)  | (8)  | (589)   |
| Other comprehensive income  | 4,944  | 86   | 5,030   |
| Balance, end of period  | \$3,940  | \$97   | \$4,037   |
| <b>Nine Months Ended September 30, 2013</b>                         |  |  |   |
| Balance, beginning of period  | \$11,568   | (\$565)  | \$11,003  |
| Other comprehensive (loss) income before reclassifications          | (8,103)  | 413  | (7,690)   |
| Amounts reclassified from accumulated other<br>comprehensive income | (945)  | 0  | (945)   |
| Other comprehensive (loss) income                                   | (9,048)  | 413  | (8,635)   |
| Balance, end of period  | \$2,520  | (\$152)  | \$2,368   |
| <b>Three Months Ended September 30, 2014</b>                        |  |  |   |
| Balance, beginning of period  | \$5,316  | \$100  | \$5,416   |
| Other comprehensive loss before reclassifications                   | (882)  | 0  | (882)   |
| Amounts reclassified from accumulated other<br>comprehensive income | (494)  | (3)  | (497)   |
| Other comprehensive loss  | (1,376)  | (3)  | (1,379)   |
| Balance, end of period  | \$3,940  | \$97   | \$4,037   |
| <b>Three Months Ended September 30, 2013</b>                        |  |  |   |
| Balance, beginning of period  | \$2,832  | (\$152)  | \$2,680   |
| Other comprehensive loss before reclassifications                   | (185)  | 0  | (185)   |
| Amounts reclassified from accumulated other<br>comprehensive income | (127)  | 0  | (127)   |
| Other comprehensive loss  | (312)  | 0  | (312)   |
| Balance, end of period  | \$2,520  | (\$152)  | \$2,368   |

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

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

**For the Nine Months Ended September 30, 2014****(In Thousands)****Details about Accumulated Other Comprehensive Income Components**

Unrealized gains and losses on available-for-sale

Securities

**Reclassified from****Accumulated Other****Comprehensive Income****Affected Line Item in the Consolidated****Statements of Income**

(\$894)

Realized gains on available-for-sale

313

Income tax provision

(581)

Net of tax

Amortization of defined benefit pension and postretirement items:

Prior service cost

(23)

Pensions and other employee benefits

Actuarial loss

11

Pensions and other employee benefits

(12)

Total before tax

4

Income tax provision

(8)

Net of tax

Total reclassifications for the period

(\$589)

**For the Nine Months Ended September 30, 2013****(In Thousands)****Details about Accumulated Other Comprehensive Income Components**

Unrealized gains and losses on available-for-sale

Securities

**Reclassified from****Accumulated Other****Comprehensive Income****Affected Line Item in the Consolidated****Statements of Income**

\$25

Total other-than-temporary impairment on available-for-sale securities

(1,477)

Realized gains on available-for-sale

(1,452)

Total before tax

507

Income tax provision

(945)

Net of tax

Amortization of defined benefit pension and postretirement items:

Prior service cost

(23)

Pensions and other employee benefits

Actuarial loss

23

Pensions and other employee benefits

0

Total before tax

0

Income tax provision

0

Net of tax

Total reclassifications for the period

(\$945)

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****For the Three Months Ended September 30, 2014  
(In Thousands)**

| <b>Details about Accumulated Other Comprehensive Income Components</b> | <b>Reclassified from Accumulated Other Comprehensive Income</b> | <b>Affected Line Item in the Consolidated Statements of Income</b> |
|--|---|--|
| Unrealized gains and losses on available-for-sale Securities           | (\$760)   | Realized gains on available-for-sale securities                    |
|  | 266   | Income tax provision   |
|  | (494)   | Net of tax   |
| Amortization of defined benefit pension and postretirement items:      |   |  |
| Prior service cost   | (7)   | Pensions and other employee benefits                               |
| Actuarial loss   | 3   | Pensions and other employee benefits                               |
|  | (4)   | Total before tax   |
|  | 1   | Income tax provision   |
|  | (3)   | Net of tax   |
| Total reclassifications for the period                                 | (\$497)   |  |

**For the Three Months Ended September 30, 2013  
(In Thousands)**

| <b>Details about Accumulated Other Comprehensive Income Components</b> | <b>Reclassified from Accumulated Other Comprehensive Income</b> | <b>Affected Line Item in the Consolidated Statements of Income</b>     |
|--|---|--|
| Unrealized gains and losses on available-for-sale Securities           | \$0   | Total other-than-temporary impairment on available-for-sale securities |
|  | (193)   | Realized gains on available-for-sale securities                        |
|  | (193)   | Total before tax   |
|  | 66  | Income tax provision   |
|  | (127)   | Net of tax   |
| Amortization of defined benefit pension and postretirement items:      |   |  |
| Prior service cost   | (7)   | Pensions and other employee benefits                                   |
| Actuarial loss   | 7   | Pensions and other employee benefits                                   |
|  | 0   | Total before tax   |
|  | 0   | Income tax provision   |
|  | 0   | Net of tax   |
| Total reclassifications for the period                                 | (\$127)   |  |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****4. CASH AND DUE FROM BANKS**

Cash and due from banks at September 30, 2014 and December 31, 2013 include the following:

| (In thousands)                | Sept. 30<br>2014 | Dec. 31,<br>2013 |
|-------------------------------|------------------|------------------|
| Cash and cash equivalents     | \$50,131         | \$38,591         |
| Certificates of deposit       | 5,308            | 6,028            |
| Total cash and due from banks | \$55,439         | \$44,619         |

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 \$12,828,000 at September 30, 2014 and \$15,318,000 at December 31, 2013.

**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 ASC topic 820, “Fair Value Measurements and Disclosures” establishes a framework for measuring fair value that includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The levels of the fair value hierarchy are as follows:

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



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

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

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

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

At September 30, 2014 and December 31, 2013, assets measured at fair value and the valuation methods used are as follows:

| (In Thousands)                                    | Quoted Prices<br>in Active<br>Markets<br>(Level 1) | September 30, 2014                         |                                     | Total<br>Fair<br>Value |
|---|--|--|-------------------------------------|------------------------|
|   |  | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) |                        |
| Recurring fair value measurements                 |  |  |                                     |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>             |  |  |                                     |                        |
| Obligations of U.S. Government agencies           | \$0  | \$26,416                                   | \$0                                 | \$26,416               |
| Obligations of states and political subdivisions: |  |  |                                     |                        |
| Tax-exempt  | 0  | 128,292                                    | 0                                   | 128,292                |
| Taxable   | 0  | 34,203                                     | 0                                   | 34,203                 |
| Mortgage-backed securities                        | 0  | 75,513                                     | 0                                   | 75,513                 |
| Collateralized mortgage obligations,              |  |  |                                     |                        |
| Issued by U.S. Government agencies                | 0  | 234,816                                    | 0                                   | 234,816                |
| Collateralized debt obligations                   | 0  | 660  | 0                                   | 660                    |
| Total debt securities                             | 0  | 499,900                                    | 0                                   | 499,900                |
| Marketable equity securities                      | 8,353  | 0  | 0                                   | 8,353                  |
| Total available-for-sale securities               | 8,353  | 499,900                                    | 0                                   | 508,253                |
| Servicing rights                                  | 0  | 0  | 1,296                               | 1,296                  |
| Total recurring fair value measurements           | \$8,353  | \$499,900                                  | \$1,296                             | \$509,549              |
| Nonrecurring fair value measurements              |  |  |                                     |                        |
| Impaired loans with a valuation allowance         | \$0  | \$0  | \$4,059                             | \$4,059                |
| Valuation allowance                               | 0  | 0  | (966)                               | (966)                  |
| Impaired loans, net                               | 0  | 0  | 3,093                               | 3,093                  |
| Foreclosed assets held for sale                   | 0  | 0  | 1,888                               | 1,888                  |
| Total nonrecurring fair value measurements        | \$0  | \$0  | \$4,981                             | \$4,981                |

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

| (In Thousands)                                    | December 31, 2013                                  |  |                                     |                        |
|---|--|--|-------------------------------------|------------------------|
|   | Quoted Prices<br>in Active<br>Markets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair<br>Value |
| Recurring fair value measurements                 |  |  |                                     |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>             |  |  |                                     |                        |
| Obligations of U.S. Government agencies           | \$0  | \$45,877                                   | \$0                                 | \$45,877               |
| Obligations of states and political subdivisions: |  |  |                                     |                        |
| Tax-exempt  | 0  | 128,426                                    | 0                                   | 128,426                |
| Taxable   | 0  | 34,471                                     | 0                                   | 34,471                 |
| Mortgage-backed securities                        | 0  | 86,208                                     | 0                                   | 86,208                 |
| Collateralized mortgage obligations,              |  |  |                                     |                        |
| Issued by U.S. Government agencies                | 0  | 178,092                                    | 0                                   | 178,092                |
| Collateralized debt obligations                   | 0  | 660  | 0                                   | 660                    |
| Total debt securities                             | 0  | 473,734                                    | 0                                   | 473,734                |
| Marketable equity securities                      | 8,924  | 0  | 0                                   | 8,924                  |
| Total available-for-sale securities               | 8,924  | 473,734                                    | 0                                   | 482,658                |
| Servicing rights                                  | 0  | 0  | 1,123                               | 1,123                  |
| Total recurring fair value measurements           | \$8,924  | \$473,734                                  | \$1,123                             | \$483,781              |
| Nonrecurring fair value measurements              |  |  |                                     |                        |
| Impaired loans with a valuation allowance         | \$0  | \$0  | \$9,889                             | \$9,889                |
| Valuation allowance                               | 0  | 0  | (2,333)                             | (2,333)                |
| Impaired loans, net                               | 0  | 0  | 7,556                               | 7,556                  |
| Foreclosed assets held for sale                   | 0  | 0  | 892                                 | 892                    |
| Total nonrecurring fair value measurements        | \$0  | \$0  | \$8,448                             | \$8,448                |

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 less estimated selling costs.

Management's evaluation and selection of valuation techniques and the unobservable inputs used in determining the fair values of assets valued using Level 3 methodologies include sensitive assumptions. Other market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amount calculated by management. At September 30, 2014 and December 31, 2013, quantitative information regarding significant techniques and inputs used for assets measured on a recurring basis using unobservable inputs (Level 3 methodologies) are as follows:

| <b>Asset</b>                                | <b>Fair Value at<br/>9/30/14<br/>(In Thousands)</b> | <b>Valuation<br/>Technique</b> | <b>Unobservable<br/>Input(s)</b> | <b>Method or Value As of<br/>9/30/14</b>              |
|---|---|--------------------------------|----------------------------------|---|
| Servicing rights                            | \$1,296   | Discounted cash flow           | Discount rate                    | 10.00% Rate used through modeling period              |
|   |   |                                | Loan prepayment speeds           | 147.00% Weighted-average PSA                          |
|   |   |                                | Servicing fees                   | 0.25% of loan balances                                |
|   |   |                                |                                  | 4.00% of payments are late                            |
|   |   |                                | Servicing costs                  | 5.00% late fees assessed                              |
|   |   |                                |                                  | \$1.94 Miscellaneous fees per account per month       |
|   |   |                                |                                  | \$6.00 Monthly servicing cost per account             |
|   |   |                                |                                  | \$24.00 Additional monthly servicing cost per account |
| 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>12/31/13<br>(In Thousands) | Valuation<br>Technique | Unobservable<br>Input(s) | Method or Value As of<br>12/31/13                     |
|------------------|---|------------------------|--------------------------|---|
| Servicing rights | \$1,123                                     | Discounted cash flow   | Discount rate            | 12.00% Rate used through modeling period              |
|                  |   |                        | Loan prepayment speeds   | 152.00% 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 account |
|                  |   |                        |                          | 1.50% of loans more than 30 days delinquent           |
|                  |   |                        |                          | 3.00% annual increase in servicing costs              |

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

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

| (In Thousands)                                 | Three Months         | Nine Months          |
|--|----------------------|----------------------|
|  | Ended Sept. 30, 2014 | Ended Sept. 30, 2014 |
|  | Servicing            | Servicing            |
|  | Rights               | Rights               |
| Balance, beginning of period                   | \$1,281              | \$1,123              |
| Issuances of servicing rights                  | 32                   | 138                  |
| Unrealized (losses) gains included in earnings | (17)                 | 35                   |
| Balance, end of period                         | \$1,296              | \$1,296              |

| (In Thousands)                  | Three Months Ended September 30, 2013  |   |                  |       | Nine Months Ended September 30, 2013   |   |                  |         |
|---------------------------------|--|---|------------------|-------|--|---|------------------|---------|
|                                 | Pooled Trust                           |   | Pooled Trust     |       | Pooled Trust                           |   | Pooled Trust     |         |
|                                 | Preferred Securities - Senior Tranches | Preferred Securities - Mezzanine Tranches | Servicing Rights | Total | Preferred Securities - Senior Tranches | Preferred Securities - Mezzanine Tranches | Servicing Rights | Total   |
| Balance, beginning of period    | \$0                                    | \$0                                       | \$850            | \$850 | \$1,613                                | \$0                                       | \$605            | \$2,218 |
| Issuances of servicing rights   | 0                                      | 0   | 120              | 120   | 0                                      | 0   | 360              | 360     |
| Accretion and amortization, net | 0                                      | 0   | 0                | 0     | (2)                                    | 0   | 0                | (2)     |
| Proceeds from sales and calls   | 0                                      | 0   | 0                | 0     | (1,636)                                | (571)                                     | 0                | (2,207) |

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|                              |     |     |         |         |     |     |         |         |
|------------------------------|-----|-----|---------|---------|-----|-----|---------|---------|
| Realized gains, net          | 0   | 0   | 0       | 0       | 23  | 571 | 0       | 594     |
| Unrealized gains included in |     |     |         |         |     |     |         |         |
| Earnings                     | 0   | 0   | 79      | 79      | 0   | 0   | 84      | 84      |
| Unrealized gains included in |     |     |         |         |     |     |         |         |
| other comprehensive income   | 0   | 0   | 0       | 0       | 2   | 0   | 0       | 2       |
| Balance, end of period       | \$0 | \$0 | \$1,049 | \$1,049 | \$0 | \$0 | \$1,049 | \$1,049 |

No other-than-temporary impairment losses (OTTI) on securities valued using Level 3 methodologies were recorded in 2014 or 2013.

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

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

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

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

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

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

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

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

discount rate and the expected prepayment speeds of the underlying loans.

**DEPOSITS** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable on demand at September 30, 2014 and December 31, 2013. The fair value of time deposits, such as certificates of deposit and Individual Retirement Accounts, is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates of deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

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

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

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



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

| (In Thousands)  | Valuation Method(s) Used | September 30, 2014 |            | December 31, 2013 |            |
|---|--------------------------|--------------------|------------|-------------------|------------|
|   |                          | Carrying Amount    | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets:</b>                                |                          |                    |            |                   |            |
| Cash and cash equivalents                               | Level 1                  | \$50,131           | \$50,131   | \$38,591          | \$38,591   |
| Certificates of deposit                                 | Level 2                  | 5,308              | 5,332      | 6,028             | 6,057      |
| Available-for-sale securities                           | See Above                | 508,253            | 508,253    | 482,658           | 482,658    |
| Restricted equity securities (included in Other Assets) | Level 2                  | 3,054              | 3,054      | 3,786             | 3,786      |
| Loans held for sale                                     | Level 1                  | 418                | 418        | 54                | 54         |
| Loans, net  | Level 3                  | 621,960            | 627,575    | 635,640           | 634,937    |
| Accrued interest receivable                             | Level 1                  | 3,964              | 3,964      | 4,146             | 4,146      |
| Servicing rights  | Level 3                  | 1,296              | 1,296      | 1,123             | 1,123      |
| <b>Financial liabilities:</b>                           |                          |                    |            |                   |            |
| Deposits with no stated maturity                        | Level 1                  | 726,740            | 726,740    | 693,479           | 693,479    |
| Time deposits   | Level 3                  | 254,789            | 255,718    | 261,037           | 262,376    |
| Short-term borrowings                                   | Level 3                  | 6,765              | 6,687      | 23,385            | 23,356     |
| Long-term borrowings                                    | Level 3                  | 73,131             | 79,160     | 73,338            | 79,400     |
| Accrued interest payable                                | Level 1                  | 97                 | 97         | 120               | 120        |

**6. SECURITIES**

Amortized cost and fair value of available-for-sale securities at September 30, 2014 and December 31, 2013 are summarized as follows:

| (In Thousands)                                    | Amortized Cost | September 30, 2014  |                      | Fair Value |
|---|----------------|---------------------|----------------------|------------|
|   |                | Gross Holding Gains | Gross Holding Losses |            |
| Obligations of U.S. Government agencies           | \$27,237       | \$43                | (\$864)              | \$26,416   |
| Obligations of states and political subdivisions: |                |                     |                      |            |
| Tax-exempt  | 123,336        | 5,142               | (186)                | 128,292    |
| Taxable   | 34,136         | 317                 | (250)                | 34,203     |
| Mortgage-backed securities                        | 74,278         | 1,482               | (247)                | 75,513     |
| Collateralized mortgage obligations,              |                |                     |                      |            |
| Issued by U.S. Government agencies                | 236,940        | 997                 | (3,121)              | 234,816    |
| Collateralized debt obligations                   | 660            | 0                   | 0                    | 660        |

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|                              |           |          |           |           |
|------------------------------|-----------|----------|-----------|-----------|
| Total debt securities        | 496,587   | 7,981    | (4,668)   | 499,900   |
| Marketable equity securities | 5,605     | 2,758    | (10)      | 8,353     |
| Total                        | \$502,192 | \$10,739 | (\$4,678) | \$508,253 |

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| (In Thousands)   | Amortized<br>Cost | December 31, 2013 |  |               |
|--|-------------------|-------------------|--|---------------|
|  |                   | Holding<br>Gains  | Gross<br>Unrealized<br>Holding<br>Losses | Fair<br>Value |
| Obligations of U.S. Government agencies                                    | \$47,382          | \$282             | (\$1,787)                                | \$45,877      |
| Obligations of states and political subdivisions:                          |                   |                   |  |               |
| Tax-exempt   | 127,748           | 2,766             | (2,088)                                  | 128,426       |
| Taxable  | 35,154            | 206               | (889)                                    | 34,471        |
| Mortgage-backed securities   | 84,849            | 1,819             | (460)                                    | 86,208        |
| Collateralized mortgage obligations,<br>Issued by U.S. Government agencies | 182,372           | 761               | (5,041)                                  | 178,092       |
| Collateralized debt obligations:   | 660               | 0                 | 0  | 660           |
| Total debt securities  | 478,165           | 5,834             | (10,265)                                 | 473,734       |
| Marketable equity securities   | 6,038             | 2,886             | 0  | 8,924         |
| Total  | \$484,203         | \$8,720           | (\$10,265)                               | \$482,658     |

The following table presents gross unrealized losses and fair value of available-for-sale securities with unrealized loss positions that are not deemed to be other-than-temporarily impaired, aggregated by length of time that individual securities have been in a continuous unrealized loss position at September 30, 2014 and December 31, 2013:

| September 30, 2014<br>(In Thousands)                                       | Less Than 12<br>Months |                      | 12 Months or More |                      | Total         |                      |
|--|------------------------|----------------------|-------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| Obligations of U.S. Government agencies                                    | \$1,584                | (\$4)                | \$23,759          | (\$860)              | \$25,343      | (\$864)              |
| Obligations of states and political subdivisions:                          |                        |                      |                   |                      |               |                      |
| Tax-exempt   | 5,935                  | (24)                 | 8,472             | (162)                | 14,407        | (186)                |
| Taxable  | 6,550                  | (35)                 | 9,868             | (215)                | 16,418        | (250)                |
| Mortgage-backed securities   | 24,304                 | (100)                | 4,241             | (147)                | 28,545        | (247)                |
| Collateralized mortgage obligations,<br>Issued by U.S. Government agencies | 96,491                 | (1,001)              | 64,549            | (2,120)              | 161,040       | (3,121)              |
| Total debt securities  | 134,864                | (1,164)              | 110,889           | (3,504)              | 245,753       | (4,668)              |
| Marketable equity securities   | 134                    | (10)                 | 0                 | 0                    | 134           | (10)                 |
| Total temporarily impaired available-for-sale<br>securities                | \$134,998              | (\$1,174)            | \$110,889         | (\$3,504)            | \$245,887     | (\$4,678)            |

| December 31, 2013<br>(In Thousands) | Less Than 12<br>Months |                      | 12 Months or More |                      | Total         |                      |
|-------------------------------------|------------------------|----------------------|-------------------|----------------------|---------------|----------------------|
|                                     | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |

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|  |           |           |          |           |           |            |
|--|-----------|-----------|----------|-----------|-----------|------------|
| Obligations of U.S. Government agencies                  | \$22,489  | (\$1,337) | \$4,598  | (\$450)   | \$27,087  | (\$1,787)  |
| Obligations of states and political subdivisions:        |           |           |          |           |           |            |
| Tax-exempt   | 44,285    | (1,425)   | 5,808    | (663)     | 50,093    | (2,088)    |
| Taxable  | 20,873    | (766)     | 2,378    | (123)     | 23,251    | (889)      |
| Mortgage-backed securities                               | 34,377    | (460)     | 0        | 0         | 34,377    | (460)      |
| Collateralized mortgage obligations,                     |           |           |          |           |           |            |
| Issued by U.S. Government agencies                       | 113,204   | (4,608)   | 7,399    | (433)     | 120,603   | (5,041)    |
| Total temporarily impaired available-for-sale securities | \$235,228 | (\$8,596) | \$20,183 | (\$1,669) | \$255,411 | (\$10,265) |

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

| (In Thousands)                   | 3 Months Ended |                | 9 Months Ended |                |
|----------------------------------|----------------|----------------|----------------|----------------|
|                                  | Sept. 30, 2014 | Sept. 30, 2013 | Sept. 30, 2014 | Sept. 30, 2013 |
| Gross realized gains from sales  | \$761          | \$193          | \$1,103        | \$1,595        |
| Gross realized losses from sales | (1)            | 0              | (209)          | (118)          |
| Losses from OTTI impairment      | 0              | 0              | 0              | (25)           |
| Net realized gains               | \$760          | \$193          | \$894          | \$1,452        |

The amortized cost and fair value of available-for-sale debt securities by contractual maturity are shown in the following table as of September 30, 2014. 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 | Fair      |
|---------------------------------------|-----------|-----------|
|                                       | Cost      | Value     |
| Due in one year or less               | \$11,087  | \$11,224  |
| Due from one year through five years  | 52,156    | 52,450    |
| Due from five years through ten years | 64,890    | 65,061    |
| Due after ten years                   | 57,236    | 60,836    |
| Subtotal                              | 185,369   | 189,571   |
| Mortgage-backed securities            | 74,278    | 75,513    |
| Collateralized mortgage obligations,  |           |           |
| Issued by U.S. Government agencies    | 236,940   | 234,816   |
| Total                                 | \$496,587 | \$499,900 |

The Corporation's mortgage-backed securities and collateralized mortgage obligations 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 \$361,581,000 at September 30, 2014 and \$323,613,000 at December 31, 2013 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 OTTI at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security or more likely than not will be required to sell the security before its anticipated recovery.

A summary of information management considered in evaluating debt and equity securities for OTTI at September 30, 2014 is provided below.

### **Debt Securities**

At September 30, 2014, 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, including municipal bonds with no external ratings, at September 30, 2014 to be temporary.

The credit rating agencies have withdrawn their ratings on numerous municipal bonds held by the Corporation. At September 30, 2014, the total amortized cost basis of municipal bonds with no external credit ratings was \$16,424,000, with an aggregate unrealized gain of \$166,000. At the time of purchase, each of these bonds was considered investment grade and had been rated by at least one credit rating agency. Most of the bonds for which credit rating agencies have

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withdrawn their ratings were insured by an entity that has reported significant financial problems and declines in its regulatory capital ratios, and most of the ratings were removed in the fourth quarter 2009. However, the insurance remains in effect on the bonds. In the third quarter 2013, a credit rating agency withdrew its ratings on several bonds due to changes in its rating methodology related to credit enhancement programs provided by issuers' state governments. However, the credit enhancement remains in effect on the bonds. None of the unrated municipal bonds has failed to make a scheduled payment.

**Equity Securities**

The Corporation's marketable equity securities at September 30, 2014 and December 31, 2013 consisted exclusively of stocks of banking companies. At September 30, 2014, the Corporation held three stocks with an unrealized loss of \$10,000 for which management determined an OTTI charge was not required.

Realized gains from sales of bank stocks totaled \$289,000 in the three-month period ended September 30, 2014 and \$363,000 in the nine-month period ended September 30, 2014. The Corporation realized gains from sales of bank stocks totaling \$188,000 in the three-month period ended September 30, 2013 and \$766,000 in the nine-month period ended September 30, 2013.

C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 12 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 \$2,924,000 at September 30, 2014 and \$3,656,000 at December 31, 2013. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at September 30, 2014 and December 31, 2013. 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.

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The loans receivable portfolio is segmented into residential mortgage, commercial and consumer loans. Loans outstanding at September 30, 2014 and December 31, 2013 are summarized by segment, and by classes within each segment, as follows:

| Summary of Loans by Type<br>(In Thousands) | Sept. 30,<br>2014 | Dec. 31,<br>2013 |
|--|-------------------|------------------|
| Residential mortgage:                      |                   |                  |
| Residential mortgage loans - first liens   | \$290,943         | \$299,831        |
| Residential mortgage loans - junior liens  | 21,843            | 23,040           |
| Home equity lines of credit                | 35,975            | 34,530           |
| 1-4 Family residential construction        | 16,895            | 13,909           |
| Total residential mortgage                 | 365,656           | 371,310          |
| Commercial:                                |                   |                  |
| Commercial loans secured by real estate    | 144,410           | 147,215          |
| Commercial and industrial                  | 50,615            | 42,387           |
| Political subdivisions                     | 14,823            | 16,291           |
| Commercial construction and land           | 9,069             | 17,003           |
| Loans secured by farmland                  | 8,542             | 10,468           |
| Multi-family (5 or more) residential       | 9,092             | 10,985           |
| Agricultural loans                         | 3,284             | 3,251            |
| Other commercial loans                     | 13,620            | 14,631           |
| Total commercial                           | 253,455           | 262,231          |
| Consumer                                   | 10,298            | 10,762           |
| Total                                      | 629,409           | 644,303          |
| Less: allowance for loan losses            | (7,449)           | (8,663)          |
| Loans, net                                 | \$621,960         | \$635,640        |

The Corporation grants loans to individuals as well as commercial and tax-exempt entities. Commercial, residential and personal loans are made to customers geographically concentrated in the Pennsylvania and New York counties that comprise the market serviced by Citizens & Northern Bank. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. There is no concentration of loans to borrowers engaged in similar businesses or activities that exceed 10% of total loans at either September 30, 2014 or December 31, 2013.

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated.



Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. In the process of evaluating the loan portfolio, management also considers the Corporation's exposure to losses from unfunded loan commitments. As of September 30, 2014 and December 31, 2013, 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 nine-month periods ended September 30, 2014 and 2013 were as follows:

| Three Months Ended September 30, 2014<br>(In Thousands) | June 30,<br>2014<br>Balance | Charge-offs   | Recoveries  | Provision (Credit) | Sept. 30,<br>2014<br>Balance |
|---|-----------------------------|---------------|-------------|--------------------|------------------------------|
| Allowance for Loan Losses:                              |                             |               |             |                    |                              |
| Residential mortgage:                                   |                             |               |             |                    |                              |
| Residential mortgage loans - first liens                | 2,966                       | (\$37)        | \$12        | \$18               | \$2,959                      |
| Residential mortgage loans - junior liens               | 280                         | 0             | 0           | (5)                | 275                          |
| Home equity lines of credit                             | 277                         | 0             | 0           | 11                 | 288                          |
| 1-4 Family residential construction                     | 173                         | 0             | 0           | 38                 | 211                          |
| Total residential mortgage                              | 3,696                       | (37)          | 12          | 62                 | 3,733                        |
| Commercial:   |                             |               |             |                    |                              |
| Commercial loans secured by real estate                 | 1,896                       | 0             | 0           | (60)               | 1,836                        |
| Commercial and industrial                               | 626                         | 0             | 1           | 40                 | 667                          |
| Political subdivisions                                  | 0                           | 0             | 0           | 0                  | 0                            |
| Commercial construction and land                        | 163                         | 0             | 0           | 145                | 308                          |
| Loans secured by farmland                               | 96                          | 0             | 0           | 58                 | 154                          |
| Multi-family (5 or more) residential                    | 103                         | 0             | 0           | (17)               | 86                           |
| Agricultural loans                                      | 30                          | 0             | 0           | 1                  | 31                           |
| Other commercial loans                                  | 135                         | 0             | 0           | (6)                | 129                          |
| Total commercial  | 3,049                       | 0             | 1           | 161                | 3,211                        |
| Consumer  | 127                         | (24)          | 12          | (5)                | 110                          |
| Unallocated   | 395                         | 0             | 0           | 0                  | 395                          |
| <b>Total Allowance for Loan Losses</b>                  | <b>\$7,267</b>              | <b>(\$61)</b> | <b>\$25</b> | <b>\$218</b>       | <b>\$7,449</b>               |

| Three Months Ended September 30, 2013<br>(In Thousands) | June 30,<br>2013<br>Balance | Charge-offs | Recoveries | Provision (Credit) | Sept. 30,<br>2013<br>Balance |
|---|-----------------------------|-------------|------------|--------------------|------------------------------|
| Allowance for Loan Losses:                              |                             |             |            |                    |                              |
| Residential mortgage:                                   |                             |             |            |                    |                              |
| Residential mortgage loans - first liens                | \$2,871                     | \$0         | \$0        | \$54               | \$2,925                      |
| Residential mortgage loans - junior liens               | 229                         | 0           | 0          | (15)               | 214                          |
| Home equity lines of credit                             | 258                         | 0           | 0          | 10                 | 268                          |
| 1-4 Family residential construction                     | 179                         | 0           | 0          | 10                 | 189                          |
| Total residential mortgage                              | 3,537                       | 0           | 0          | 59                 | 3,596                        |
| Commercial:   |                             |             |            |                    |                              |

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|   |         |         |      |       |         |
|---|---------|---------|------|-------|---------|
| Commercial loans secured by real estate | 1,944   | (169)   | 50   | (163) | 1,662   |
| Commercial and industrial               | 628     | (176)   | 1    | 143   | 596     |
| Political subdivisions                  | 0       | 0       | 0    | 0     | 0       |
| Commercial construction and land        | 258     | 0       | 0    | 136   | 394     |
| Loans secured by farmland               | 121     | 0       | 0    | (4)   | 117     |
| Multi-family (5 or more) residential    | 64      | 0       | 0    | (9)   | 55      |
| Agricultural loans                      | 28      | 0       | 0    | 0     | 28      |
| Other commercial loans                  | 5       | 0       | 0    | 86    | 91      |
| Total commercial                        | 3,048   | (345)   | 51   | 189   | 2,943   |
| Consumer                                | 215     | (29)    | 16   | (9)   | 193     |
| Unallocated                             | 398     | 0       | 0    | 0     | 398     |
| <br>                                    |         |         |      |       |         |
| Total Allowance for Loan Losses         | \$7,198 | (\$374) | \$67 | \$239 | \$7,130 |

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| Nine Months Ended September 30, 2014<br>(In Thousands) | December 31,<br>2013<br>Balance | Charge-offs      | Recoveries   | Provision (Credit) | Sept. 30,<br>2014<br>Balance |
|--|---------------------------------|------------------|--------------|--------------------|------------------------------|
| Allowance for Loan Losses:                             |                                 |                  |              |                    |                              |
| Residential mortgage:                                  |                                 |                  |              |                    |                              |
| Residential mortgage loans - first liens               | \$2,974                         | (\$96)           | \$13         | \$68               | \$2,959                      |
| Residential mortgage loans - junior liens              | 294                             | 0                | 0            | (19)               | 275                          |
| Home equity lines of credit                            | 269                             | 0                | 0            | 19                 | 288                          |
| 1-4 Family residential construction                    | 168                             | 0                | 0            | 43                 | 211                          |
| Total residential mortgage                             | 3,705                           | (96)             | 13           | 111                | 3,733                        |
| Commercial:  |                                 |                  |              |                    |                              |
| Commercial loans secured by real estate                | 3,123                           | (1,521)          | 250          | (16)               | 1,836                        |
| Commercial and industrial                              | 591                             | (24)             | 9            | 91                 | 667                          |
| Political subdivisions                                 | 0                               | 0                | 0            | 0                  | 0                            |
| Commercial construction and land                       | 267                             | (170)            | 5            | 206                | 308                          |
| Loans secured by farmland                              | 115                             | 0                | 0            | 39                 | 154                          |
| Multi-family (5 or more) residential                   | 103                             | 0                | 0            | (17)               | 86                           |
| Agricultural loans                                     | 30                              | 0                | 0            | 1                  | 31                           |
| Other commercial loans                                 | 138                             | 0                | 0            | (9)                | 129                          |
| Total commercial                                       | 4,367                           | (1,715)          | 264          | 295                | 3,211                        |
| Consumer   | 193                             | (70)             | 37           | (50)               | 110                          |
| Unallocated  | 398                             | 0                | 0            | (3)                | 395                          |
| <b>Total Allowance for Loan Losses</b>                 | <b>\$8,663</b>                  | <b>(\$1,881)</b> | <b>\$314</b> | <b>\$353</b>       | <b>\$7,449</b>               |

| Nine Months Ended September 30, 2013<br>(In Thousands) | December 31,<br>2012<br>Balance | Charge-offs | Recoveries | Provision (Credit) | Sept. 30,<br>2013<br>Balance |
|--|---------------------------------|-------------|------------|--------------------|------------------------------|
| Allowance for Loan Losses:                             |                                 |             |            |                    |                              |
| Residential mortgage:                                  |                                 |             |            |                    |                              |
| Residential mortgage loans - first liens               | \$2,619                         | (\$65)      | \$11       | \$360              | \$2,925                      |
| Residential mortgage loans - junior liens              | 247                             | 0           | 0          | (33)               | 214                          |
| Home equity lines of credit                            | 255                             | 0           | 0          | 13                 | 268                          |
| 1-4 Family residential construction                    | 96                              | (11)        | 0          | 104                | 189                          |
| Total residential mortgage                             | 3,217                           | (76)        | 11         | 444                | 3,596                        |
| Commercial:  |                                 |             |            |                    |                              |
| Commercial loans secured by real estate                | 1,930                           | (169)       | 343        | (442)              | 1,662                        |
| Commercial and industrial                              | 581                             | (286)       | 3          | 298                | 596                          |
| Political subdivisions                                 | 0                               | 0           | 0          | 0                  | 0                            |
| Commercial construction and land                       | 234                             | (4)         | 0          | 164                | 394                          |
| Loans secured by farmland                              | 129                             | 0           | 0          | (12)               | 117                          |
| Multi-family (5 or more) residential                   | 67                              | 0           | 0          | (12)               | 55                           |
| Agricultural loans                                     | 27                              | 0           | 0          | 1                  | 28                           |
| Other commercial loans                                 | 3                               | 0           | 0          | 88                 | 91                           |

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|                                 |         |         |       |       |         |
|---------------------------------|---------|---------|-------|-------|---------|
| Total commercial                | 2,971   | (459)   | 346   | 85    | 2,943   |
| Consumer                        | 228     | (84)    | 47    | 2     | 193     |
| Unallocated                     | 441     | 0       | 0     | (43)  | 398     |
| Total Allowance for Loan Losses | \$6,857 | (\$619) | \$404 | \$488 | \$7,130 |

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

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

The following tables summarize the aggregate credit quality classification of outstanding loans by risk rating as of September 30, 2014 and December 31, 2013:

| <b>September 30, 2014</b>                 | <b>Special</b> |                |                    |                 |                |
|---|----------------|----------------|--------------------|-----------------|----------------|
| <b>(In Thousands)</b>                     | <b>Pass</b>    | <b>Mention</b> | <b>Substandard</b> | <b>Doubtful</b> | <b>Total</b>   |
| <b>Residential Mortgage:</b>              |                |                |                    |                 |                |
| Residential mortgage loans - first liens  | \$278,183      | \$1,707        | \$10,974           | \$79            | \$290,943      |
| Residential mortgage loans - junior liens | 20,765         | 328            | 750                | 0               | 21,843         |
| Home equity lines of credit               | 35,272         | 244            | 459                | 0               | 35,975         |
| 1-4 Family residential construction       | 16,874         | 210            |                    | 0               | 16,895         |
| <b>Total residential mortgage</b>         | <b>351,094</b> | <b>2,300</b>   | <b>12,183</b>      | <b>79</b>       | <b>365,656</b> |
| <b>Commercial:</b>                        |                |                |                    |                 |                |
| Commercial loans secured by real estate   | 131,571        | 3,363          | 9,476              | 0               | 144,410        |
| Commercial and Industrial                 | 42,551         | 4,665          | 3,164              | 235             | 50,615         |
| Political subdivisions                    | 14,823         | 0              |                    | 0               | 14,823         |
| Commercial construction and land          | 6,592          | 284            | 2,107              | 86              | 9,069          |
| Loans secured by farmland                 | 6,108          | 535            | 1,872              | 27              | 8,542          |
| Multi-family (5 or more) residential      | 8,795          | 296            | 1                  | 0               | 9,092          |
| Agricultural loans                        | 3,244          | 0              | 40                 | 0               | 3,284          |
| Other commercial loans                    | 13,531         | 890            |                    | 0               | 13,620         |
| <b>Total Commercial</b>                   | <b>227,215</b> | <b>9,232</b>   | <b>16,660</b>      | <b>348</b>      | <b>253,455</b> |

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|          |           |          |          |       |           |
|----------|-----------|----------|----------|-------|-----------|
| Consumer | 10,173    | 1        | 124      | 0     | 10,298    |
| Totals   | \$588,482 | \$11,533 | \$28,967 | \$427 | \$629,409 |

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| <b>(In Thousands)</b>                     | <b>Pass</b>      | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Doubtful</b> | <b>Total</b>     |
|---|------------------|----------------------------|--------------------|-----------------|------------------|
| <b>Residential Mortgage:</b>              |                  |                            |                    |                 |                  |
| Residential mortgage loans - first liens  | \$286,144        | \$1,876                    | \$11,629           | \$182           | \$299,831        |
| Residential mortgage loans - junior liens | 21,694           | 351                        | 995                | 0               | 23,040           |
| Home equity lines of credit               | 33,821           | 295                        | 414                | 0               | 34,530           |
| 1-4 Family residential construction       | 13,837           | 0                          | 72                 | 0               | 13,909           |
| <b>Total residential mortgage</b>         | <b>355,496</b>   | <b>2,522</b>               | <b>13,110</b>      | <b>182</b>      | <b>371,310</b>   |
| <b>Commercial:</b>                        |                  |                            |                    |                 |                  |
| Commercial loans secured by real estate   | 129,834          | 5,866                      | 11,368             | 147             | 147,215          |
| Commercial and Industrial                 | 32,317           | 6,697                      | 3,138              | 235             | 42,387           |
| Political subdivisions                    | 16,291           | 0                          | 0                  | 0               | 16,291           |
| Commercial construction and land          | 13,792           | 427                        | 2,036              | 748             | 17,003           |
| Loans secured by farmland                 | 8,279            | 758                        | 1,402              | 29              | 10,468           |
| Multi-family (5 or more) residential      | 10,665           | 316                        | 4                  | 0               | 10,985           |
| Agricultural loans                        | 3,169            | 34                         | 48                 | 0               | 3,251            |
| Other commercial loans                    | 14,532           | 990                        | 0                  | 0               | 14,631           |
| <b>Total commercial</b>                   | <b>228,879</b>   | <b>14,197</b>              | <b>17,996</b>      | <b>1,159</b>    | <b>262,231</b>   |
| <b>Consumer</b>                           | <b>10,587</b>    | <b>6</b>                   | <b>169</b>         | <b>0</b>        | <b>10,762</b>    |
| <b>Totals</b>                             | <b>\$594,962</b> | <b>\$16,725</b>            | <b>\$31,275</b>    | <b>\$1,341</b>  | <b>\$644,303</b> |

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

The qualitative factors used in the general component calculations are designed to address credit risk characteristics associated with each segment. The Corporation's credit risk associated with all of the segments is significantly impacted by these factors, which include economic conditions within its market area, the Corporation's lending policies, changes or trends in the portfolio, risk profile, competition, regulatory requirements and other factors. Further, the residential mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation's commercial segment loans (approximately 68% at September 30, 2014) is secured by real estate, and accordingly, the Corporation's risk for the commercial segment is significantly affected by commercial real estate values. The consumer segment includes a wide mix of loans for different purposes, primarily secured loans, including loans secured by motor vehicles, manufactured housing and



other types of collateral.

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

The scope of loans evaluated individually for impairment include all loan relationships greater than \$200,000 for which there is at least one extension of credit graded Special Mention, Substandard or Doubtful. Also, all loans classified as troubled debt restructurings (discussed in more detail below) and all loan relationships less than \$200,000 in the aggregate, but with an estimated loss of \$100,000 or more, are individually evaluated for impairment. Loans that are

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individually evaluated for impairment, but which are not determined to be impaired, are combined with all remaining loans that are not reviewed on a specific basis, and such loans are included within larger pools of loans based on similar risk and loss characteristics for purposes of determining the general component of the allowance. The loans that have been individually evaluated, but which have not been determined to be impaired, are included in the “Collectively Evaluated” column in the tables summarizing the allowance and associated loan balances as of September 30, 2014 and December 31, 2013.

The following tables present a summary of loan balances and the related allowance for loan losses summarized by portfolio segment and class for each impairment method used as of September 30, 2014 and December 31, 2013:

| September 30, 2014<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  | \$2,498                   | \$288,445                 | \$290,943        | \$449                      | \$2,510                   | \$2,959        |
| Residential mortgage loans - junior liens | 181                       | 21,662                    | 21,843           | 100                        | 175                       | 275            |
| Home equity lines of credit               | 0                         | 35,975                    | 35,975           | 0                          | 288                       | 288            |
| 1-4 Family residential construction       | 0                         | 16,895                    | 16,895           | 0                          | 211                       | 211            |
| Total residential mortgage                | 2,679                     | 362,977                   | 365,656          | 549                        | 3,184                     | 3,733          |
| <b>Commercial:</b>                        |                           |                           |                  |                            |                           |                |
| Commercial loans secured by real estate   | 6,692                     | 137,718                   | 144,410          | 18                         | 1,818                     | 1,836          |
| Commercial and industrial                 | 765                       | 49,850                    | 50,615           | 98                         | 569                       | 667            |
| Political subdivisions                    | 0                         | 14,823                    | 14,823           | 0                          | 0                         | 0              |
| Commercial construction and land          | 2,109                     | 6,960                     | 9,069            | 211                        | 97                        | 308            |
| Loans secured by farmland                 | 1,809                     | 6,733                     | 8,542            | 90                         | 64                        | 154            |
| Multi-family (5 or more) residential      | 0                         | 9,092                     | 9,092            | 0                          | 86                        | 86             |
| Agricultural loans                        | 40                        | 3,244                     | 3,284            | 0                          | 31                        | 31             |
| Other commercial loans                    | 0                         | 13,620                    | 13,620           | 0                          | 129                       | 129            |
| Total commercial                          | 11,415                    | 242,040                   | 253,455          | 417                        | 2,794                     | 3,211          |
| Consumer                                  | 0                         | 10,298                    | 10,298           | 0                          | 110                       | 110            |
| Unallocated                               |                           |                           |                  |                            |                           | 395            |
| <b>Total</b>                              | <b>\$14,094</b>           | <b>\$615,315</b>          | <b>\$629,409</b> | <b>\$966</b>               | <b>\$6,088</b>            | <b>\$7,449</b> |

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| December 31, 2013<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  | \$2,727                   | \$297,104                 | \$299,831        | \$449                      | \$2,525                   | \$2,974        |
| Residential mortgage loans - junior liens | 183                       | 22,857                    | 23,040           | 100                        | 194                       | 294            |
| Home equity lines of credit               | 0                         | 34,530                    | 34,530           | 0                          | 269                       | 269            |
| 1-4 Family residential construction       | 0                         | 13,909                    | 13,909           | 0                          | 168                       | 168            |
| <b>Total residential mortgage</b>         | <b>2,910</b>              | <b>368,400</b>            | <b>371,310</b>   | <b>549</b>                 | <b>3,156</b>              | <b>3,705</b>   |
| <b>Commercial:</b>                        |                           |                           |                  |                            |                           |                |
| Commercial loans secured by real estate   | 7,988                     | 139,227                   | 147,215          | 1,577                      | 1,546                     | 3,123          |
| Commercial and industrial                 | 1,276                     | 41,111                    | 42,387           | 106                        | 485                       | 591            |
| Political subdivisions                    | 0                         | 16,291                    | 16,291           | 0                          | 0                         | 0              |
| Commercial construction                   | 2,776                     | 14,227                    | 17,003           | 72                         | 195                       | 267            |
| Loans secured by farmland                 | 1,318                     | 9,150                     | 10,468           | 29                         | 86                        | 115            |
| Multi-family (5 or more) residential      | 0                         | 10,985                    | 10,985           | 0                          | 103                       | 103            |
| Agricultural loans                        | 48                        | 3,203                     | 3,251            | 0                          | 30                        | 30             |
| Other commercial loans                    | 0                         | 14,631                    | 14,631           | 0                          | 138                       | 138            |
| <b>Total commercial</b>                   | <b>13,406</b>             | <b>248,825</b>            | <b>262,231</b>   | <b>1,784</b>               | <b>2,583</b>              | <b>4,367</b>   |
| Consumer                                  | 5                         | 10,757                    | 10,762           | 0                          | 193                       | 193            |
| Unallocated                               |                           |                           |                  |                            |                           | 398            |
| <b>Total</b>                              | <b>\$16,321</b>           | <b>\$627,982</b>          | <b>\$644,303</b> | <b>\$2,333</b>             | <b>\$5,932</b>            | <b>\$8,663</b> |

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

| (In Thousands)  | 3 Months<br>Ended<br>Sept. 30, |         | 9 Months<br>Ended<br>Sept. 30, |         |
|---|--------------------------------|---------|--------------------------------|---------|
|   | 2014                           | 2013    | 2014                           | 2013    |
| Average investment in impaired loans                            | \$14,611                       | \$8,773 | \$14,870                       | \$8,032 |
| Interest income recognized on impaired loans                    | 130                            | 163     | 503                            | 291     |
| Interest income recognized on a cash basis<br>on impaired loans | 130                            | 163     | 503                            | 291     |

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 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.

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

| (In Thousands)                            | September 30, 2014                   |            | December 31, 2013                    |            |
|---|--------------------------------------|------------|--------------------------------------|------------|
|   | Past Due<br>90+ Days and<br>Accruing |            | Past Due<br>90+ Days and<br>Accruing |            |
|   | Nonaccrual                           | Nonaccrual | Nonaccrual                           | Nonaccrual |
| Residential mortgage:                     |                                      |            |                                      |            |
| Residential mortgage loans - first liens  | \$1,589                              | \$3,677    | \$2,016                              | \$3,533    |
| Residential mortgage loans - junior liens | 130                                  | 151        | 187                                  | 110        |
| Home equity lines of credit               | 35                                   | 86         | 87                                   | 62         |
| 1-4 Family residential construction       | 0                                    | 0          | 0                                    | 72         |
| Total residential mortgage                | 1,754                                | 3,914      | 2,290                                | 3,777      |
| Commercial:                               |                                      |            |                                      |            |
| Commercial loans secured by real estate   | 703                                  | 5,931      | 744                                  | 7,096      |
| Commercial and industrial                 | 5                                    | 450        | 17                                   | 434        |
| Commercial construction and land          | 110                                  | 2,001      | 5                                    | 2,663      |
| Loans secured by farmland                 | 29                                   | 1,361      | 0                                    | 902        |
| Agricultural loans                        | 0                                    | 40         | 0                                    | 35         |
| Total commercial                          | 847                                  | 9,783      | 766                                  | 11,130     |
| Consumer                                  | 1                                    | 25         | 75                                   | 27         |
| Totals                                    | \$2,602                              | \$13,722   | \$3,131                              | \$14,934   |

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

The table below presents a summary of the contractual aging of loans as of September 30, 2014 and December 31, 2013:

| (In Thousands)        | As of September 30, 2014 |            |          |           | As of December 31, 2013 |            |          |           |
|-----------------------|--------------------------|------------|----------|-----------|-------------------------|------------|----------|-----------|
|                       | Current &                |            |          |           | Current &               |            |          |           |
|                       | Past Due                 | Past Due   | Past Due | Total     | Past Due                | Past Due   | Past Due | Total     |
|                       | Less than 30 Days        | 30-89 Days | 90+ Days |           | Less than 30 Days       | 30-89 Days | 90+ Days |           |
| Residential mortgage: | \$284,215                | \$3,457    | \$3,271  | \$290,943 | \$289,483               | \$6,776    | \$3,572  | \$299,831 |

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|   |           |         |         |           |           |         |         |           |
|---|-----------|---------|---------|-----------|-----------|---------|---------|-----------|
| Residential mortgage loans - first liens  |           |         |         |           |           |         |         |           |
| Residential mortgage loans - junior liens | 21,325    | 246     | 272     | 21,843    | 22,247    | 506     | 287     | 23,040    |
| Home equity lines of credit               | 35,766    | 88      | 121     | 35,975    | 34,263    | 118     | 149     | 34,530    |
| 1-4 Family residential construction       | 16,895    | 0       | 0       | 16,895    | 13,837    | 0       | 72      | 13,909    |
| Total residential mortgage                | 358,201   | 3,791   | 3,664   | 365,656   | 359,830   | 7,400   | 4,080   | 371,310   |
| Commercial:                               |           |         |         |           |           |         |         |           |
| Commercial loans secured by real estate   | 141,669   | 1,480   | 1,261   | 144,410   | 145,055   | 405     | 1,755   | 147,215   |
| Commercial and industrial                 | 50,199    | 277     | 139     | 50,615    | 41,730    | 434     | 223     | 42,387    |
| Political subdivisions                    | 14,823    | 0       | 0       | 14,823    | 16,291    | 0       | 0       | 16,291    |
| Commercial construction and land          | 6,916     | 42      | 2,111   | 9,069     | 14,303    | 32      | 2,668   | 17,003    |
| Loans secured by farmland                 | 6,922     | 230     | 1,390   | 8,542     | 9,267     | 329     | 872     | 10,468    |
| Multi-family (5 or more) residential      | 8,796     | 296     | 0       | 9,092     | 10,985    | 0       | 0       | 10,985    |
| Agricultural loans                        | 3,238     | 6       | 40      | 3,284     | 3,203     | 13      | 35      | 3,251     |
| Other commercial loans                    | 13,620    | 0       | 0       | 13,620    | 14,631    | 0       | 0       | 14,631    |
| Total commercial                          | 246,183   | 2,331   | 4,941   | 253,455   | 255,465   | 1,213   | 5,553   | 262,231   |
| Consumer                                  | 10,212    | 85      | 1       | 10,298    | 10,516    | 171     | 75      | 10,762    |
| Totals                                    | \$614,596 | \$6,207 | \$8,606 | \$629,409 | \$625,811 | \$8,784 | \$9,708 | \$644,303 |

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Nonaccrual loans are included in the contractual aging in the immediately preceding table. A summary of the contractual aging of nonaccrual loans at September 30, 2014 and December 31, 2013 is as follows:

| (In Thousands)                       | Current &                        |                           |                         | Total    |
|--------------------------------------|----------------------------------|---------------------------|-------------------------|----------|
|                                      | Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days |          |
| September 30, 2014 Nonaccrual Totals | \$6,969                          | \$749                     | \$6,004                 | \$13,722 |
| December 31, 2013 Nonaccrual Totals  | \$7,878                          | \$479                     | \$6,577                 | \$14,934 |

Loans whose terms are modified are classified as Troubled Debt Restructurings (TDRs) if the Corporation grants such borrowers concessions, and it is deemed that those borrowers are experiencing financial difficulty. Loans classified as TDRs are designated as impaired. The outstanding balance of loans subject to TDRs, as well as contractual aging information at September 30, 2014 and December 31, 2013 is as follows:

| (In Thousands)            | Current &                        |                           |                         | Nonaccrual | Total   |
|---------------------------|----------------------------------|---------------------------|-------------------------|------------|---------|
|                           | Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days |            |         |
| September 30, 2014 Totals | \$1,325                          | \$509                     | \$171                   | \$6,001    | \$8,006 |
| December 31, 2013 Totals  | \$3,254                          | \$13                      | \$0                     | \$908      | \$4,175 |

There were no TDRs that occurred during the three-month periods ended September 30, 2014 and 2013. TDRs that occurred during the nine-month periods ended September 30, 2014 and 2013 were as follows:

| Nine Months Ended September 30, 2014<br>(Balances in Thousands)   | Number<br>of<br>Contracts | Pre-  | Post-   |
|---|---------------------------|---|---|
|   |                           | Modification<br>Outstanding<br>Recorded<br>Investment | Modification<br>Outstanding<br>Recorded<br>Investment |
| Residential mortgage,<br>Residential mortgage loans - first liens | 3                         | \$150   | \$150   |
| Commercial:<br>Commercial loans secured by real estate            | 5                         | 6,679   | 5,193   |
| Commercial and industrial   | 1                         | 80  | 80  |
| Nine Months Ended September 30, 2013<br>(Balances in Thousands)   |                           | Pre-<br>Modification                                  | Post-<br>Modification                                 |

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|   | Number<br>of<br>Contracts | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
|---|---------------------------|---------------------------------------|---------------------------------------|
| Residential mortgage:                     |                           |                                       |                                       |
| Residential mortgage loans - first liens  | 6                         | \$677                                 | \$677                                 |
| Residential mortgage loans - junior liens | 3                         | 102                                   | 102                                   |
| Commercial:                               |                           |                                       |                                       |
| Commercial loans secured by real estate   | 1                         | 440                                   | 440                                   |
| Loans secured by farmland                 | 4                         | 512                                   | 512                                   |
| Agricultural loans                        | 1                         | 13                                    | 13                                    |
| Consumer                                  | 1                         | 6                                     | 6                                     |



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The TDRs in the nine-month period ended September 30, 2014 related to residential mortgage loans included a reduction in payment amount on one contract, an interest only period on one contract and a reduction in interest rate and payment on one contract. The TDRs related to commercial loans in the nine-month period ended September 30, 2014 relate to six contracts associated with one relationship. The Corporation entered into a forbearance agreement with this commercial borrower which includes a reduction in monthly payment amounts over a fifteen-month period. At the end of the fifteen-month period, the monthly payment amounts would revert to the original amounts, unless the forbearance agreement is extended or the payment requirements are otherwise modified. The Corporation recorded a charge-off of \$1,486,000 in the second quarter 2014 as a result of these modifications, as the payment amounts based on the forbearance agreement are not sufficient to fully amortize the contractual amount of principal outstanding on the loans. The amount of the charge-off was determined based on the excess of the contractual principal due over the present value of the payment amounts provided for in the forbearance agreement, assuming the revised payment amounts would continue until maturity, at the contractual interest rates. After the effect of the \$1,486,000 charge-off related to loans to one commercial borrower described above, there was no allowance for loan losses on loans to that borrower at September 30, 2014, while the allowance on the loans amounted to \$1,552,000 at December 31, 2013. There were no other changes in the allowance for loan losses related to TDRs that occurred during the nine-month period ended September 30, 2014.

The TDRs in the nine-month period ended September 30, 2013 included interest only payments for an extended period of time on ten contracts, extensions of the final maturity date on three contracts, reduction in interest rate on two contracts, and reduction in payment amount for one year on one contract. There was no allowance for loan losses on these loans at September 30, 2013 and no change in the allowance for loan losses resulting from these TDRs during the nine-month period ended September 30, 2013.

In the third quarter of 2014 and 2013, there were no defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months. In the nine-month periods ended September 30, 2014 and 2013, defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months were as follows:

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Nine Months Ended September 30, 2014<br>(Balances in Thousands) |                           |                        |
| Residential mortgage:   |                           |                        |
| Residential mortgage loans - first liens                        | 2                         | \$223                  |
| Residential mortgage loans - junior liens                       | 1                         | 62                     |
| Commercial:   |                           |                        |
| Loans secured by real estate                                    | 1                         | 429                    |
| Loans secured by farmland                                       | 4                         | 490                    |
| Agricultural  | 1                         | 13                     |

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Nine Months Ended September 30, 2013<br>(Balances in Thousands) |                           |                        |
| Commercial,   |                           |                        |
| Commercial loans secured by real estate                         | 1                         | \$440                  |

In the nine-month period ended September 30, 2014, the events of default in the table listed above included a borrower's failure to make reduced payments provided for at a reduced interest rate on a first lien residential mortgage. The other events of default listed above in the nine-month periods ended September 30, 2014 resulted from the borrowers' failure to make interest only monthly payments. There were no allowances for loan losses recorded on these loans at September 30, 2014.

In the nine-month period ended September 30, 2013, the event of default listed in the table resulted from the borrower's failure to make interest only payments. There was no allowance for loan losses recorded on this loan at September 30, 2013.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****8. BORROWED FUNDS****SHORT-TERM BORROWINGS**

Short-term borrowings include the following:

| (In Thousands)                 | Sept. 30,<br>2014 | Dec. 31,<br>2013 |
|--------------------------------|-------------------|------------------|
| FHLB-Pittsburgh borrowings     | \$0               | \$20,000         |
| Customer repurchase agreements | 6,765             | 3,385            |
| Total short-term borrowings    | \$6,765           | \$23,385         |

The FHLB-Pittsburgh loan facilities are collateralized by qualifying loans secured by real estate with a book value totaling \$446,404,000 at September 30, 2014 and \$453,792,000 at December 31, 2013. 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 \$2,924,000 at September 30, 2014 and \$3,656,000 at December 31, 2013.

The short-term borrowing from the FHLB-Pittsburgh matured in January 2014 and had an interest rate of 0.24%.

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 rate paid by the Corporation on customer repurchase agreements was 0.10% at September 30, 2014 and December 31, 2013. The carrying value of the underlying securities was \$10,824,000 at September 30, 2014 and \$11,269,000 at December 31, 2013.

**LONG-TERM BORROWINGS**

Long-term borrowings are as follows:

| (In Thousands)             | Sept. 30,<br>2014 | Dec. 31,<br>2013 |
|----------------------------|-------------------|------------------|
| FHLB-Pittsburgh borrowings | \$12,131          | \$12,338         |
| Repurchase agreements      | 61,000            | 61,000           |
| Total long-term borrowings | \$73,131          | \$73,338         |

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

| (In Thousands)                             | Sept. 30,<br>2014 | Dec. 31,<br>2013 |
|--|-------------------|------------------|
| Loan maturing in 2016 with a rate of 6.86% | \$119             | \$153            |
| Loan maturing in 2017 with a rate of 6.83% | 18                | 22               |

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|  |          |          |
|--|----------|----------|
| Loan maturing in 2017 with a rate of 3.81% | 10,000   | 10,000   |
| Loan maturing in 2020 with a rate of 4.79% | 1,027    | 1,146    |
| Loan maturing in 2025 with a rate of 4.91% | 967      | 1,017    |
| Total long-term FHLB-Pittsburgh borrowings | \$12,131 | \$12,338 |

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Repurchase agreements included in long-term borrowings are as follows:

| (In Thousands)                                   | Sept. 30,<br>2014 | Dec. 31,<br>2013 |
|--|-------------------|------------------|
| Agreement maturing in 2017 with a rate of 3.595% | \$27,000          | \$27,000         |
| Agreement maturing in 2017 with a rate of 4.265% | 34,000            | 34,000           |
| Total long-term repurchase agreements            | \$61,000          | \$61,000         |

The Corporation incurred a loss of \$1,023,000 in the first quarter of 2013 on prepayment of \$7,000,000 of the agreement with an interest rate of 3.595%. Each of these borrowings is puttable by the issuer at quarterly intervals.

Securities sold under repurchase agreements were delivered to the broker-dealer who is the counter-party to the transactions. The broker-dealer may have sold, loaned or otherwise disposed of such securities to other parties in the normal course of their operations, and has agreed to resell to the Corporation substantially identical securities at the maturities of the agreements. The Master Repurchase Agreement between the Corporation and the broker-dealer provides that the Agreement constitutes a “netting contract,” as defined; however, the Corporation and the broker-dealer have no other obligations to one another and accordingly, no netting has occurred. The carrying value of the underlying securities was \$73,837,000 at September 30, 2014 and \$79,814,000 at December 31, 2013.

**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. Effective January 1, 2013, this plan was amended so that full-time employees no longer accrue service time toward the Corporation-subsidized portion of the medical benefits. The plan was also amended effective January 1, 2013 to change some of the age and length-of-service requirements for participants to receive some of the benefits provided under the plan. This plan contains a cost-sharing feature, which causes participants to pay for all future increases in costs related to benefit coverage. Accordingly, actuarial assumptions related to health care cost trend rates do not significantly affect the liability balance at September 30, 2014 and December 31, 2013, 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.

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

| (In Thousands)                     | Pension           |                | Postretirement    |                |
|------------------------------------|-------------------|----------------|-------------------|----------------|
|                                    | Nine Months Ended |                | Nine Months Ended |                |
|                                    | Sept. 30, 2014    | Sept. 30, 2013 | Sept. 30, 2014    | Sept. 30, 2013 |
| Service cost                       | \$0               | \$0            | \$26              | \$31           |
| Interest cost                      | 55                | 53             | 43                | 41             |
| Expected return on plan assets     | (66)              | (68)           | 0                 | 0              |
| Amortization of prior service cost | 0                 | 0              | (23)              | (23)           |
| Recognized net actuarial loss      | 11                | 23             | 0                 | 0              |
| Net periodic benefit cost          | \$0               | \$8            | \$46              | \$49           |

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|                                    | Pension<br>Three<br>Months<br>Ended<br>Sept. 30, |      | Postretirement<br>Three Months<br>Ended<br>Sept. 30, |      |
|------------------------------------|--|------|--|------|
|                                    | 2014   | 2013 | 2014   | 2013 |
| Service cost                       | \$0  | \$0  | \$9  | \$10 |
| Interest cost                      | 18   | 17   | 14   | 13   |
| Expected return on plan assets     | (22)   | (23) | 0  | 0    |
| Amortization of prior service cost | 0  | 0    | (7)  | (7)  |
| Recognized net actuarial loss      | 3  | 7    | 0  | 0    |
| Net periodic benefit cost          | (\$1)  | \$1  | \$16   | \$16 |

In the first nine months of 2014, the Corporation funded postretirement contributions totaling \$42,000, with estimated annual postretirement contributions of \$60,000 expected in 2014 for the full year. The Corporation made no contribution to the defined benefit pension plan in the nine months of 2014. Based upon the related actuarial reports, no defined benefit pension contributions are required in 2014, though the Corporation may make discretionary contributions.

**10. STOCK-BASED COMPENSATION PLANS**

In January 2014, the Corporation granted options to purchase a total of 39,027 shares of common stock through its Stock Incentive and Independent Directors Stock Incentive Plans. In January 2013, the Corporation granted options to purchase a total of 64,050 shares of common stock. The exercise price for the 2014 awards is \$20.45 per share, and the exercise price for the 2013 awards is \$19.21 per share, based on the market price as of the date of grant. Stock option expense is recognized over the vesting period of each option. The Corporation expects total stock option expense for the year ending December 31, 2014 will be \$154,000, and total stock option expense for the year ended December 31, 2013 was \$242,000.

The Corporation records stock option expense based on estimated fair value calculated using an option valuation model. In calculating the 2014 and 2013 fair values, the Corporation utilized the Black-Scholes-Merton option-pricing model. The calculated fair value of each option granted, and significant assumptions used in the calculations, are as follows:

|                                   | <b>2014</b> | <b>2013</b> |
|-----------------------------------|-------------|-------------|
| Fair value of each option granted | \$5.50      | \$5.56      |
| Volatility                        | 39%         | 41%         |
| Expected option lives             | 8 Years     | 8 Years     |

|                         |       |       |
|-------------------------|-------|-------|
| Risk-free interest rate | 2.85% | 1.60% |
| Dividend yield          | 4.33% | 3.69% |

In calculating the estimated fair value of stock option awards, management based its estimates of volatility and dividend yield on the Corporation's experience over the immediately prior period of time consistent with the estimated lives of the options. The risk-free interest rate was based on the published yield of zero-coupon U.S. Treasury strips with an applicable maturity as of the grant dates. The expected option lives were based on management's estimates of the average term for all options issued under both plans. In 2014, management assumed a 34% forfeiture rate for options granted under the Stock Incentive Plan, and a 3% forfeiture rate for the Directors Stock Incentive Plan. In 2013, management assumed a 33% forfeiture rate for options granted under the Stock Incentive Plan, and a 0% forfeiture rate for the Directors Stock Incentive Plan. These estimated forfeiture rates were determined based on the Corporation's historical experience.

In January 2014, the Corporation awarded a total of 16,711 shares of restricted stock under the Stock Incentive and Independent Directors Stock Incentive Plans. In January 2013, a total of 37,886 shares of restricted stock were awarded under the Plans. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. For most of the restricted stock awards granted under the Stock Incentive Plan, the Corporation must meet an annual targeted return on average equity ("ROAE") performance ratio, as defined, in order for participants to vest. Management has estimated restricted stock expense in the first nine months of 2014 based on an assumption that the ROAE target for 2014 will be met. For 2014 restricted stock awards under the Stock Incentive Plan to individuals who are substantially involved in mortgage lending, and for restricted stock awards under the Independent Directors Stock Incentive Plan, vesting is not dependent on the Corporation's ROAE.



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Total stock-based compensation expense is as follows:

| (In Thousands)   | 3 Months Ended    |                   | 9 Months Ended    |                   |
|------------------|-------------------|-------------------|-------------------|-------------------|
|                  | Sept. 30,<br>2014 | Sept. 30,<br>2013 | Sept. 30,<br>2014 | Sept. 30,<br>2013 |
| Stock options    | \$0               | \$0               | \$154             | \$262             |
| Restricted stock | 79                | 113               | 309               | 343               |
| <b>Total</b>     | <b>\$79</b>       | <b>\$113</b>      | <b>\$463</b>      | <b>\$605</b>      |

**11. INCOME TAXES**

The net deferred tax asset at September 30, 2014 and December 31, 2013 represents the following temporary difference components:

| (In Thousands)                          | Sept. 30,<br>2014 | December 31,<br>2013 |
|---|-------------------|----------------------|
| <b>Deferred tax assets:</b>             |                   |                      |
| Unrealized holding losses on securities | \$0               | \$541                |
| Net realized losses on securities       | 144               | 91                   |
| Allowance for loan losses               | 2,607             | 3,032                |
| Credit for alternative minimum tax paid | 1,073             | 1,905                |
| Other deferred tax assets               | 2,443             | 2,332                |
| <b>Total deferred tax assets</b>        | <b>6,267</b>      | <b>7,901</b>         |
| <b>Deferred tax liabilities:</b>        |                   |                      |
| Unrealized holding gains on securities  | 2,121             | 0                    |
| Defined benefit plans - ASC 835         | 52                | 6                    |
| Bank premises and equipment             | 1,193             | 1,314                |
| Core deposit intangibles                | 21                | 30                   |
| Other deferred tax liabilities          | 207               | 207                  |
| <b>Total deferred tax liabilities</b>   | <b>3,594</b>      | <b>1,557</b>         |
| <b>Deferred tax asset, net</b>          | <b>\$2,673</b>    | <b>\$6,344</b>       |

The provision for income tax for the three-month and nine-month periods ended September 30, 2014 and 2013 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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| (In thousands)                     | Three Months  |         | Nine Months   |          |
|------------------------------------|---------------|---------|---------------|----------|
|                                    | Ended         |         | Ended         |          |
|                                    | September 30, |         | September 30, |          |
|                                    | 2014          | 2013    | 2014          | 2013     |
| Income before income tax provision | \$5,678       | \$6,268 | \$16,928      | \$19,203 |
| Income tax provision               | 1,411         | 1,579   | 4,210         | 4,834    |
| Effective tax rate                 | 24.85%        | 25.19%  | 24.88%        | 25.17%   |

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

The Corporation has investments in three limited partnerships that manage affordable housing projects that have qualified for the federal low-income housing tax credit. The Corporation's expected return from these investments is based on the receipt of tax credits and tax benefits from deductions of operating losses. The Corporation uses the effective yield method to account for these investments, with the benefits recognized as a reduction of the provision for income taxes. For two of the three limited partnership investments, the tax credits have been received in full in prior years, and the Corporation has fully realized the benefits of the credits and amortized its initial investments in the partnerships. The most recent affordable housing project was completed in 2013, and the Corporation received tax credits in 2013 and expects to continue to receive tax credits annually through 2022. The carrying amount of the Corporation's investment is \$929,000

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at September 30, 2014 and \$996,000 at December 31, 2013 (included in Other Assets in the consolidated balance sheets). For the year ending December 31, 2014, the estimated amount of tax credits and other tax benefits to be received is \$159,000 and the estimated amount to be recognized as a reduction of the provision for income taxes is \$83,000. For the year ended December 31, 2013, tax credits and other tax benefits totaled \$160,000 and the amount recognized as a reduction of the provision for income taxes for 2013 was \$85,000. The reduction in the provision for income taxes resulting from this investment totaled \$21,000 in the third quarter 2014 and \$62,000 for the nine months ended September 30, 2014, and \$21,000 in the third quarter 2013 and \$64,000 for nine months ended September 30, 2013.

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 2010.

**12. CONTINGENCIES**

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

**13. RECENT ACCOUNTING PRONOUNCEMENTS**

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

In July 2013, the FASB issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The amendments in this standard clarify that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with

deferred tax assets. For the Corporation, the amendments in this Update are effective beginning in the first quarter 2014. The Corporation will be affected by these amendments if unrecognized tax benefits arise in future periods.

In December 2013, the FASB issued ASU 2013-12, Definition of a Public Business Entity. The amendment in this Update provides a single definition of public business entity for use in future financial accounting and reporting guidance. The amendment does not affect existing requirements and does not have an effective date. The amendment specifies the following: (1) an entity that is required by the Securities and Exchange Commission (SEC) to file or furnish financial statements with the SEC, or does file or furnish financial statements with the SEC, is considered a public entity, (2) a consolidated subsidiary of a public company is not considered a public business entity for purposes of its standalone financial statements other than those included in an SEC filing by its parent or by other registrants or those that are issuers and are required to file or furnish financial statements with the SEC, and (3) a business entity that has securities that are not subject to contractual restrictions on transfer and that is by law, contract or regulation required to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis is considered a public business entity. Based on this definition, Citizens & Northern Corporation is considered a public business entity, while the individual subsidiaries are not considered to be public business entities for purposes of their standalone financial statements.

In January 2014, the FASB issued ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. This Update provides guidance on accounting for investments in flow-through limited liability entities that qualify for the federal low-income housing tax credit. Currently, under U.S. GAAP, a reporting entity that invests in a qualified affordable housing project may elect to account for that investment using the effective yield method if certain conditions are met, or alternatively, the investment would be accounted for under either the equity method or the cost method. Generally, investors in qualified affordable housing project investments expect to receive all of their return through the receipt of tax credits and tax deductions from operating losses, and use of the effective yield method results in recognition of the return

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as a reduction of income tax expense over the period of the investment. The amendments in this Update modify the conditions that a reporting entity must meet to be eligible to use a method other than the equity or cost methods to

account for investments in qualified affordable housing projects. Additionally, the amendments introduce new recurring disclosure requirements about investments in qualified affordable housing projects. The amendments in this Update are effective for the Corporation for annual and interim periods beginning in the first quarter 2015, and are to be applied retrospectively. Information concerning the Corporation's investments in qualified affordable housing projects is provided in Note 11 to these unaudited consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The objective of the amendments in this Update is to reduce diversity among reporting entities by clarifying when an in substance foreclosure occurs. The amendments in this Update clarify that an in substance foreclosure occurs, and a creditor is considered to have received physical possession of residential real property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to the requirements of the applicable jurisdiction. An entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method. Under the modified retrospective transition method, an entity would record a cumulative-effect adjustment to residential consumer mortgage loans and foreclosed residential real estate properties existing as of the beginning of the annual period for which the amendments are effective. For prospective transition, an entity would apply the amendments to all instances of an entity receiving physical possession of residential real estate property collateralizing consumer mortgage loans that occur after the date of adoption. Early adoption is permitted. The amendments in this Update are effective for the Corporation for annual and interim periods beginning in the first quarter 2015, and the Corporation is in the process of determining how it will apply the amendments to its accounting and reporting practices.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which provides a principles-based framework for revenue recognition that supersedes virtually all previously issued revenue recognition guidance under U.S. GAAP. Additionally, the ASU requires improved disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue that is recognized. The core principle of the five-step revenue recognition framework is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU will be effective for all annual and interim periods beginning in the first quarter 2017. The amendments in the ASU should be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this ASU recognized at the date of initial application. The Corporation is in the process of evaluating the potential impact of adopting this ASU, including determining which transition method to apply.

In June 2014, the FASB issued ASU 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. In addition to various other amendments that will affect accounting and disclosures for transactions in which the Corporation has not engaged to date, this Update requires expanded disclosures for repurchase agreements that are accounted for as secured borrowings, including: (1) a disaggregation of the gross obligation by the class of collateral pledged, (2) the remaining contractual tenor of the agreements and (3) a discussion of the potential risks associated with the agreements and the related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed. The expanded disclosure requirements associated with repurchase agreements are effective for the Corporation for annual and interim periods beginning in the second quarter 2015. Information concerning the Corporation's repurchase agreements is provided in Note 8 to these unaudited consolidated financial statements.

In August 2014, the FASB issued ASU 2014-14, Receivables – Troubled Debt Restructuring by Creditors, which requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under the claim and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. The amendments in this Update are effective for the Corporation for annual and interim periods beginning in the first quarter 2015.

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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 in the third quarter 2014 totaled \$4,267,000, or \$0.34 per basic and diluted share, up from \$0.33 per share in the second quarter 2014 and down from \$0.38 per share in the third quarter 2013. For the nine months ended September 30, 2014, net income was \$12,718,000, or \$1.02 per basic and diluted share, down from \$1.16 per share for the first nine months of 2013. Earnings results for the nine months ended September 30, 2014 reflected an annualized return on average assets of 1.37% and an annualized return on average equity of 9.18%.

Some of the more significant fluctuations in the components of earnings between the third quarter and second quarter of 2014, and between the three-month and nine-month periods ended September 30, 2014 and the corresponding periods in 2013 are as follows:

Net interest income of \$10,285,000 in the third quarter 2014 was up slightly from the second quarter 2014, reflecting increases compared to the prior quarter in average balances of deposits of \$14,979,000, available-for-sale securities of \$9,548,000 and loans outstanding of \$4,321,000. Third quarter 2014 net interest income was down 3.3% from the third quarter 2013 and net interest income for the first nine months of 2014 was down \$1,942,000 (6.0%) from the first nine months of 2013. Yields earned on securities and loans have fallen by more than interest rates paid on deposits and borrowings over the course of 2013 and the first nine months of 2014. The net interest margin was 3.75% in the third quarter 2014, down from 3.84% in the second quarter 2014 and 3.97% in the third quarter 2013. For the first nine months of 2014, the net interest margin was 3.82% as compared to 4.10% for the first nine months of 2013. The average balance of loans outstanding was \$33.3 million (5.0%) lower in the first nine months of 2014 as compared to the first nine months of 2013.

The provision for loan losses was \$218,000 in the third quarter 2014 as compared to \$446,000 in the second quarter 2014 and \$239,000 in the third quarter 2013. For the first nine months of 2014, the provision for loan losses totaled \$353,000, down from \$488,000 for the first nine months of 2013.

Noninterest revenue of \$3,887,000 in the third quarter 2014 was down \$93,000 (2.3%) from the second quarter 2014, and down \$406,000 (9.5%) from the third quarter 2013. For the first nine months of 2014, noninterest revenue was \$709,000 (5.8%) lower than in the first nine months of 2013. Gains from sales of residential mortgage loans totaled \$557,000 in the first nine months of 2014, down from \$1,560,000 in the first nine months of 2013, reflecting lower volume from refinancing activity. Total trust and brokerage revenue of \$4,007,000 in the first nine months of 2014 was \$399,000 (11.1%) higher than the total in the first nine months of 2013.



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In the third quarter 2014, realized gains from available-for-sale securities totaled \$760,000, including gains from sales of mortgage-backed securities and other debt securities totaling \$471,000 and gains from sales of equity securities (bank stocks) totaling \$289,000. In comparison, realized gains from available-for-sale securities totaled \$103,000 in the second quarter 2014 and \$193,000 in the third quarter 2013. Realized gains from available-for-sale securities totaled \$894,000 in the first nine months of 2014, while in the first nine months of 2013 realized gains from securities totaled \$1,452,000 and losses from prepayment of borrowings totaled \$1,023,000.

Noninterest expenses totaled \$9,036,000 in the third quarter 2014, up from \$8,347,000 in the second quarter 2014 and \$8,610,000 in the third quarter 2013. In the third quarter 2014, salaries and wages expense increased \$702,000 over the second quarter 2014, and \$812,000 over the third quarter 2013, mainly because of severance expenses. In the first nine months of 2014, total noninterest expenses, excluding losses from prepayment of borrowings, were \$224,000 (0.9%) higher than in the first nine months of 2013. Salaries and wages expense increased \$788,000 in the first nine months of 2014 as compared to the corresponding period in 2013, mainly as a result of severance benefits, and pensions and other employee benefit expenses increased \$398,000, mainly due to higher health care costs. Professional fees expense was \$997,000 lower in the first nine months of 2014 as compared to the first nine months of 2013, as the total in 2013 included fees associated with projects designed to identify sources of noninterest revenue and reductions in debit card and ATM processing expense.

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

**TABLE I - QUARTERLY FINANCIAL DATA**  
(In Thousands)

|   | Sept. 30,<br>2014 | June 30,<br>2014 | Mar. 31,<br>2014 | Dec. 31,<br>2013 | Sept. 30,<br>2013 | June 30,<br>2013 | Mar. 31,<br>2013 |
|---|-------------------|------------------|------------------|------------------|-------------------|------------------|------------------|
| Interest income   | \$11,572          | \$11,563         | \$11,406         | \$11,885         | \$12,027          | \$12,355         | \$12,647         |
| Interest expense  | 1,287             | 1,290            | 1,288            | 1,354            | 1,396             | 1,415            | 1,600            |
| Net interest income   | 10,285            | 10,273           | 10,118           | 10,531           | 10,631            | 10,940           | 11,047           |
| Provision (credit) for loan losses                              | 218               | 446              | (311)            | 1,559            | 239               | 66               | 183              |
| Net Interest income after provision (credit)<br>for loan losses | 10,067            | 9,827            | 10,429           | 8,972            | 10,392            | 10,874           | 10,864           |
| Other income  | 3,887             | 3,980            | 3,751            | 4,124            | 4,293             | 4,191            | 3,843            |
| Net gains on available-for-sale securities                      | 760               | 103              | 31               | 266              | 193               | 100              | 1,159            |
| Loss on prepayment of debt                                      | 0                 | 0                | 0                | 0                | 0                 | 0                | 1,023            |
| Other expenses  | 9,036             | 8,347            | 8,524            | 7,788            | 8,610             | 8,520            | 8,553            |
| Income before income tax provision                              | 5,678             | 5,563            | 5,687            | 5,574            | 6,268             | 6,645            | 6,290            |
| Income tax provision  | 1,411             | 1,400            | 1,399            | 1,349            | 1,579             | 1,671            | 1,584            |
| Net income  | \$4,267           | \$4,163          | \$4,288          | \$4,225          | \$4,689           | \$4,974          | \$4,706          |
| Net income per share – basic                                    | \$0.34            | \$0.33           | \$0.35           | \$0.34           | \$0.38            | \$0.40           | \$0.38           |
| Net income per share – diluted                                  | \$0.34            | \$0.33           | \$0.34           | \$0.34           | \$0.38            | \$0.40           | \$0.38           |

## 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

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allowance based on their judgments of information available to them at the time of their examination.

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

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

### **NET INTEREST INCOME**

The Corporation's primary source of operating income is net interest income, which is equal to the difference between the amounts of interest income and interest expense. Tables II, III and IV include information regarding the Corporation's net interest income for the three-month and nine-month periods ended September 30, 2014 and September 30, 2013. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest income amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the related Tables.

#### **Nine-Month Periods Ended September 30, 2014 and 2013**

For the nine-month periods, fully taxable equivalent net interest income was \$32,946,000 in 2014, \$2,118,000 (6.0%) lower than in 2013. As shown in Table IV, interest rate changes had the effect of decreasing net interest income \$1,341,000 and changes in volume had the effect of decreasing net interest income \$777,000 in 2014 compared to 2013. The most significant components of the rate-related change in net interest income in 2014 were a decrease in interest income of \$1,422,000 attributable to lower rates earned on loans receivable and a decrease in interest income of \$244,000 attributable to lower rates earned on available-for-sale securities, partially offset by a decrease in interest expense of \$314,000 due to lower rates paid on interest-bearing deposits. The most significant components of the volume-related change in net interest income in 2014 were a decrease in interest income of \$1,398,000 attributable to

a decline in the balance of loans receivable, partially offset by an increase in interest income of \$415,000 from an increase in available-for-sale securities, a decrease in interest expense of \$134,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit) and a decrease in interest expense of \$105,000 attributable to a reduction in the balance of borrowed funds. As presented in Table III, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.66% in 2014, as compared to 3.92% in 2013.

#### INTEREST INCOME AND EARNING ASSETS

Interest income totaled \$36,811,000 in 2014, a decrease of 6.7% from 2013. Interest and fees on loans receivable decreased \$2,820,000, or 9.9%. The average balance of gross loans receivable decreased 5.0% to \$627,810,000 in 2014 from \$661,144,000 in 2013. The Corporation experienced contraction in the balance of loans receivable due to borrowers prepaying or refinancing existing loans combined with modest demand for new loans. The decline in the balance of the residential mortgage portfolio was also affected by management's decision to sell a significant portion of newly originated residential mortgages on the secondary market. The Corporation's average rate of return on loans receivable declined to 5.48% in 2014 from 5.77% in 2013 as rates on new loans have decreased.

As indicated in Table III, average available-for-sale securities (at amortized cost) totaled \$491,361,000 in 2014, an increase of \$35,469,000 (7.8%) from 2013. The net increase in the Corporation's available-for-sale securities portfolio was primarily made up of mortgage-backed securities and collateralized mortgage obligations issued or guaranteed by U.S. Government agencies. The Corporation's yield on securities was lower in 2014 than in 2013, primarily because of lower market interest rates. The average rate of return on available-for-sale securities was 2.98% for 2014 and 3.17% in 2013.

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**INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES**

Interest expense fell \$546,000, or 12.4%, to \$3,865,000 in 2014 from \$4,411,000 in 2013. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 0.61% in 2014 from 0.69% in 2013.

Total average deposits (interest-bearing and noninterest-bearing) decreased 0.2%, to \$963,212,000 in 2014 from \$965,126,000 in 2013. Decreases in the average balances of certificates of deposit, Individual Retirement Accounts, and money market accounts were partially offset by increases in average balances of demand deposits, interest checking and savings accounts. Consistent with continuing low short-term market interest rates, the average rates incurred on certificates of deposit have decreased significantly in 2014 as compared to 2013.

Total average borrowed funds decreased \$2,797,000 to \$79,927,000 in 2014 from \$82,724,000 in 2013.

**Three-Month Periods Ended September 30, 2014 and 2013**

For the three-month periods, fully taxable equivalent net interest income was \$11,031,000 in 2014, which was \$398,000 (3.5%) lower than in 2013. As shown in Table IV, interest rate changes had the effect of decreasing net interest income \$252,000 and net changes in volume had the effect of decreasing net interest income \$146,000 in 2014 compared to 2013. As presented in Table III, the “Interest Rate Spread” was 3.59% in 2014, as compared to 3.81% in 2013.

Interest income totaled \$12,318,000 in 2014, a decrease of \$507,000 (4.0%) from 2013. Income from available-for-sale securities increased \$178,000 (5.0%), while interest and fees from loans receivable decreased \$684,000, or 7.4%. As indicated in Table III, total average available-for-sale securities (at amortized cost) in 2014 increased to \$505,782,000 from \$466,270,000 in 2013. The average rate of return on available-for-sale securities was 2.91% for 2014, down from 3.00% in 2013. For the three-month period, the average balance of gross loans receivable decreased 3.6% to \$626,336,000 in 2014 from \$650,030,000 in 2013. The average rate of return on loans was 5.43% in 2014, down from 5.65% in 2013.

For the three-month period, interest expense fell \$109,000, or 7.8%, to \$1,287,000 in 2014 from \$1,396,000 in 2013. Total average deposits (interest-bearing and noninterest-bearing) amounted to \$979,530,000 in the third quarter 2014, an increase of \$20,714,000 (2.2%) over the third quarter 2013 total. The average interest rate on interest-bearing liabilities was 0.60% in the third quarter 2014 as compared to 0.65% in the third quarter 2013.



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

| (In Thousands)                      | Three Months Ended |          | Increase/<br>(Decrease) | Nine Months Ended |          | Increase/<br>(Decrease) |
|-------------------------------------|--------------------|----------|-------------------------|-------------------|----------|-------------------------|
|                                     | Sept. 30,<br>2014  | 2013     |                         | Sept. 30,<br>2014 | 2013     |                         |
| <b>INTEREST INCOME</b>              |                    |          |                         |                   |          |                         |
| Available-for-sale securities:      |                    |          |                         |                   |          |                         |
| Taxable                             | \$2,076            | \$1,724  | \$352                   | \$5,994           | \$5,249  | \$745                   |
| Tax-exempt                          | 1,632              | 1,806    | (174)                   | 4,975             | 5,549    | (574)                   |
| Total available-for-sale securities | 3,708              | 3,530    | 178                     | 10,969            | 10,798   | 171                     |
| Interest-bearing due from banks     | 33                 | 25       | 8                       | 95                | 76       | 19                      |
| Federal funds sold                  | 0                  | 0        | 0                       | 0                 | 0        | 0                       |
| Loans held for sale                 | 5                  | 14       | (9)                     | 13                | 47       | (34)                    |
| Loans receivable:                   |                    |          |                         |                   |          |                         |
| Taxable                             | 8,040              | 8,742    | (702)                   | 24,123            | 26,995   | (2,872)                 |
| Tax-exempt                          | 532                | 514      | 18                      | 1,611             | 1,559    | 52                      |
| Total loans receivable              | 8,572              | 9,256    | (684)                   | 25,734            | 28,554   | (2,820)                 |
| Total Interest Income               | 12,318             | 12,825   | (507)                   | 36,811            | 39,475   | (2,664)                 |
| <b>INTEREST EXPENSE</b>             |                    |          |                         |                   |          |                         |
| Interest-bearing deposits:          |                    |          |                         |                   |          |                         |
| Interest checking                   | 55                 | 53       | 2                       | 161               | 156      | 5                       |
| Money market                        | 73                 | 72       | 1                       | 214               | 218      | (4)                     |
| Savings                             | 31                 | 29       | 2                       | 90                | 87       | 3                       |
| Certificates of deposit             | 264                | 362      | (98)                    | 833               | 1,198    | (365)                   |
| Individual Retirement Accounts      | 120                | 130      | (10)                    | 352               | 438      | (86)                    |
| Other time deposits                 | 0                  | 1        | (1)                     | 0                 | 1        | (1)                     |
| Total interest-bearing deposits     | 543                | 647      | (104)                   | 1,650             | 2,098    | (448)                   |
| Borrowed funds:                     |                    |          |                         |                   |          |                         |
| Short-term                          | 1                  | 3        | (2)                     | 7                 | 6        | 1                       |
| Long-term                           | 743                | 746      | (3)                     | 2,208             | 2,307    | (99)                    |
| Total borrowed funds                | 744                | 749      | (5)                     | 2,215             | 2,313    | (98)                    |
| Total Interest Expense              | 1,287              | 1,396    | (109)                   | 3,865             | 4,411    | (546)                   |
| Net Interest Income                 | \$11,031           | \$11,429 | (\$398)                 | \$32,946          | \$35,064 | (\$2,118)               |

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

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TABLE III - ANALYSIS OF AVERAGE DAILY BALANCES AND RATES

(Dollars in Thousands)

|  | 3 Months<br>Ended<br>9/30/2014<br>Average<br>Balance |  | 3 Months<br>Ended<br>9/30/2013<br>Average<br>Balance |  | 9 Months<br>Ended<br>9/30/2014<br>Average<br>Balance |  | 9 Months<br>Ended<br>9/30/2013<br>Average<br>Balance |  |
|--|--|--|--|--|--|--|--|--|
|  | Rate of<br>Return/<br>Cost of<br>Funds %             | Rate of<br>Return/<br>Cost of<br>Funds % | Rate of<br>Return/<br>Cost of<br>Funds %             | Rate of<br>Return/<br>Cost of<br>Funds % | Rate of<br>Return/<br>Cost of<br>Funds %             | Rate of<br>Return/<br>Cost of<br>Funds % | Rate of<br>Return/<br>Cost of<br>Funds %             | Rate of<br>Return/<br>Cost of<br>Funds % |
| <b>EARNING ASSETS</b>                                |  |  |  |  |  |  |  |  |
| Available-for-sale securities,<br>at amortized cost: |  |  |  |  |  |  |  |  |
| Taxable  | \$381,833  | 2.16%                                    | \$335,439  | 2.04%                                    | \$366,853  | 2.18%                                    | \$324,839  | 2.16%                                    |
| Tax-exempt   | 123,949  | 5.22%                                    | 130,831  | 5.48%                                    | 124,508  | 5.34%                                    | 131,053  | 5.66%                                    |
| Total available-for-sale securities                  | 505,782  | 2.91%                                    | 466,270  | 3.00%                                    | 491,361  | 2.98%                                    | 455,892  | 3.17%                                    |
| Interest-bearing due from banks                      | 35,133   | 0.37%                                    | 24,795   | 0.40%                                    | 32,798   | 0.39%                                    | 25,808   | 0.39%                                    |
| Federal funds sold                                   | 0  | 0.00%                                    | 0  | 0.00%                                    | 0  | 0.00%                                    | 6  | 0.00%                                    |
| Loans held for sale                                  | 263  | 7.54%                                    | 1,032  | 5.38%                                    | 222  | 7.83%                                    | 1,333  | 4.71%                                    |
| Loans receivable:                                    |  |  |  |  |  |  |  |  |
| Taxable  | 587,799  | 5.43%                                    | 615,318  | 5.64%                                    | 589,607  | 5.47%                                    | 625,527  | 5.77%                                    |
| Tax-exempt   | 38,537   | 5.48%                                    | 34,712   | 5.87%                                    | 38,203   | 5.64%                                    | 35,617   | 5.85%                                    |
| Total loans receivable                               | 626,336  | 5.43%                                    | 650,030  | 5.65%                                    | 627,810  | 5.48%                                    | 661,144  | 5.77%                                    |
| Total Earning Assets                                 | 1,167,514  | 4.19%                                    | 1,142,127  | 4.46%                                    | 1,152,191  | 4.27%                                    | 1,144,183  | 4.61%                                    |
| Cash   | 17,361   |  | 17,698   |  | 17,052   |  | 16,919   |  |
| Unrealized gain/loss on securities                   | 7,810  |  | 1,688  |  | 5,719  |  | 10,539   |  |
| Allowance for loan losses                            | (7,332)  |  | (7,258)  |  | (8,166)  |  | (7,205)  |  |
| Bank premises and equipment                          | 16,581   |  | 17,950   |  | 16,915   |  | 18,316   |  |
| Intangible Asset - Core Deposit Intangible           | 64   |  | 105  |  | 74   |  | 119  |  |
| Intangible Asset - Goodwill                          | 11,942   |  | 11,942   |  | 11,942   |  | 11,942   |  |
| Other assets   | 40,201   |  | 43,690   |  | 41,156   |  | 43,400   |  |
| Total Assets   | \$1,254,141  |  | \$1,227,942  |  | \$1,236,883  |  | \$1,238,213  |  |
| <b>INTEREST-BEARING LIABILITIES</b>                  |  |  |  |  |  |  |  |  |
| Interest-bearing deposits:                           |  |  |  |  |  |  |  |  |
| Interest checking                                    | \$186,034  | 0.12%                                    | \$172,010  | 0.12%                                    | \$181,580  | 0.12%                                    | \$171,180  | 0.12%                                    |
| Money market   | 202,536  | 0.14%                                    | 205,168  | 0.14%                                    | 198,987  | 0.14%                                    | 203,925  | 0.14%                                    |
| Savings  | 123,447  | 0.10%                                    | 116,474  | 0.10%                                    | 121,257  | 0.10%                                    | 116,745  | 0.10%                                    |
| Certificates of deposit                              | 137,136  | 0.76%                                    | 144,689  | 0.99%                                    | 136,748  | 0.81%                                    | 151,630  | 1.06%                                    |
| Individual Retirement Accounts                       | 120,079  | 0.40%                                    | 127,526  | 0.40%                                    | 121,143  | 0.39%                                    | 130,633  | 0.45%                                    |
| Other time deposits                                  | 1,525  | 0.00%                                    | 1,556  | 0.25%                                    | 1,161  | 0.00%                                    | 1,190  | 0.11%                                    |
| Total interest-bearing deposits                      | 770,757  | 0.28%                                    | 767,423  | 0.33%                                    | 760,876  | 0.29%                                    | 775,303  | 0.36%                                    |
| Borrowed funds:                                      |  |  |  |  |  |  |  |  |
| Short-term   | 5,325  | 0.07%                                    | 7,944  | 0.15%                                    | 6,696  | 0.14%                                    | 5,963  | 0.13%                                    |
| Long-term  | 73,162   | 4.03%                                    | 73,436   | 4.03%                                    | 73,231   | 4.03%                                    | 76,761   | 4.02%                                    |
| Total borrowed funds                                 | 78,487   | 3.76%                                    | 81,380   | 3.65%                                    | 79,927   | 3.71%                                    | 82,724   | 3.74%                                    |
| Total Interest-bearing Liabilities                   | 849,244  | 0.60%                                    | 848,803  | 0.65%                                    | 840,803  | 0.61%                                    | 858,027  | 0.69%                                    |



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|  |             |             |             |             |
|--|-------------|-------------|-------------|-------------|
| Demand deposits  | 208,773     | 191,393     | 202,336     | 189,823     |
| Other liabilities  | 10,975      | 10,030      | 9,045       | 9,070       |
| Total Liabilities  | 1,068,992   | 1,050,226   | 1,052,184   | 1,056,920   |
| Stockholders' equity, excluding<br>other comprehensive income/loss | 180,042     | 176,772     | 180,912     | 174,726     |
| Other comprehensive income/loss                                    | 5,107       | 944         | 3,787       | 6,567       |
| Total Stockholders' Equity   | 185,149     | 177,716     | 184,699     | 181,293     |
| Total Liabilities and Stockholders' Equity                         | \$1,254,141 | \$1,227,942 | \$1,236,883 | \$1,238,213 |
| Interest Rate Spread   | 3.59%       | 3.81%       | 3.66%       | 3.92%       |
| Net Interest Income/Earning Assets                                 | 3.75%       | 3.97%       | 3.82%       | 4.10%       |
| <br>   |             |             |             |             |
| Total Deposits (Interest-bearing<br>and Demand)                    | \$979,530   | \$958,816   | \$963,212   | \$965,126   |

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

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

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

| (In Thousands)                      | 3 Months Ended 9/30/14 vs. 9/30/13 |                |              | 9 Months Ended 9/30/14 vs. 9/30/13 |                |              |
|-------------------------------------|------------------------------------|----------------|--------------|------------------------------------|----------------|--------------|
|                                     | Change in Volume                   | Change in Rate | Total Change | Change in Volume                   | Change in Rate | Total Change |
| <b>EARNING ASSETS</b>               |                                    |                |              |                                    |                |              |
| Available-for-sale securities:      |                                    |                |              |                                    |                |              |
| Taxable                             | \$251                              | \$101          | \$352        | \$685                              | \$60           | \$745        |
| Tax-exempt                          | (93)                               | (81)           | (174)        | (270)                              | (304)          | (574)        |
| Total available-for-sale securities | 158                                | 20             | 178          | 415                                | (244)          | 171          |
| Interest-bearing due from banks     | 10                                 | (2)            | 8            | 20                                 | (1)            | 19           |
| Federal funds sold                  | 0                                  | 0              | 0            | 0                                  | 0              | 0            |
| Loans held for sale                 | (12)                               | 3              | (9)          | (53)                               | 19             | (34)         |
| Loans receivable:                   |                                    |                |              |                                    |                |              |
| Taxable                             | (380)                              | (322)          | (702)        | (1,508)                            | (1,364)        | (2,872)      |
| Tax-exempt                          | 54                                 | (36)           | 18           | 110                                | (58)           | 52           |
| Total loans receivable              | (326)                              | (358)          | (684)        | (1,398)                            | (1,422)        | (2,820)      |
| Total Interest Income               | (170)                              | (337)          | (507)        | (1,016)                            | (1,648)        | (2,664)      |
| <b>INTEREST-BEARING LIABILITIES</b> |                                    |                |              |                                    |                |              |
| Interest-bearing deposits:          |                                    |                |              |                                    |                |              |
| Interest checking                   | 4                                  | (2)            | 2            | 9                                  | (4)            | 5            |
| Money market                        | (1)                                | 2              | 1            | (5)                                | 1              | (4)          |
| Savings                             | 1                                  | 1              | 2            | 3                                  | 0              | 3            |
| Certificates of deposit             | (18)                               | (80)           | (98)         | (110)                              | (255)          | (365)        |
| Individual Retirement Accounts      | (8)                                | (2)            | (10)         | (31)                               | (55)           | (86)         |
| Other time deposits                 | 0                                  | (1)            | (1)          | 0                                  | (1)            | (1)          |
| Total interest-bearing deposits     | (22)                               | (82)           | (104)        | (134)                              | (314)          | (448)        |
| Borrowed funds:                     |                                    |                |              |                                    |                |              |
| Short-term                          | 0                                  | (2)            | (2)          | 1                                  | 0              | 1            |
| Long-term                           | (2)                                | (1)            | (3)          | (106)                              | 7              | (99)         |
| Total borrowed funds                | (2)                                | (3)            | (5)          | (105)                              | 7              | (98)         |
| Total Interest Expense              | (24)                               | (85)           | (109)        | (239)                              | (307)          | (546)        |
| Net Interest Income                 | (\$146)                            | (\$252)        | (\$398)      | (\$777)                            | (\$1,341)      | (\$2,118)    |

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

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

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TABLE V - COMPARISON OF NONINTEREST INCOME

(In Thousands)

|   | 9 Months Ended    |          |              |             |
|---|-------------------|----------|--------------|-------------|
|   | Sept. 30,<br>2014 | 2013     | \$<br>Change | %<br>Change |
| Service charges on deposit accounts   | \$3,812           | \$3,825  | (\$13)       | (0.3)       |
| Service charges and fees  | 405               | 444      | (39)         | (8.8)       |
| Trust and financial management revenue  | 3,325             | 3,022    | 303          | 10.0        |
| Brokerage revenue   | 682               | 586      | 96           | 16.4        |
| Insurance commissions, fees and premiums  | 103               | 136      | (33)         | (24.3)      |
| Interchange revenue from debit card transactions  | 1,474             | 1,453    | 21           | 1.4         |
| Net gains from sales of loans   | 557               | 1,560    | (1,003)      | (64.3)      |
| Increase in fair value of servicing rights  | 35                | 84       | (49)         | (58.3)      |
| Increase in cash surrender value of life insurance  | 278               | 301      | (23)         | (7.6)       |
| Net gain from premises and equipment  | 8                 | 14       | (6)          | (42.9)      |
| Other operating income  | 939               | 902      | 37           | 4.1         |
| Total other operating income before realized gains<br>on available-for-sale securities, net | \$11,618          | \$12,327 | (\$709)      | (5.8)       |

Table V excludes realized gains on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table V decreased \$709,000 or 5.8%, in the first nine months of 2014 as compared to the same period in 2013. The most significant variances include the following:

Net gains from sales of loans decreased \$1,003,000, or 64.3%. Since December 2009, the Corporation has sold a significant amount of residential mortgage loans into the secondary market through the MPF programs administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The decrease in revenue in 2014 reflects decreases in volume, including the impact of less refinancing activity.

Trust and financial management revenue increased \$303,000, or 10.0%, as a result of growth in assets under management resulting from market appreciation as well as new business.

Brokerage revenue increased \$96,000, or 16.4%, as a result of increased annuity sales.

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

TABLE VI - COMPARISON OF NONINTEREST INCOME

(In Thousands)

|  | 3 Months Ended |                |           |          |
|--|----------------|----------------|-----------|----------|
|  | Sept. 30, 2014 | Sept. 30, 2013 | \$ Change | % Change |
| Service charges on deposit accounts  | \$1,275        | \$1,357        | (\$82)    | (6.0)    |
| Service charges and fees   | 144            | 165            | (21)      | (12.7)   |
| Trust and financial management revenue   | 1,140          | 1,033          | 107       | 10.4     |
| Brokerage revenue  | 213            | 205            | 8         | 3.9      |
| Insurance commissions, fees and premiums   | 44             | 32             | 12        | 37.5     |
| Interchange revenue from debit card transactions   | 504            | 484            | 20        | 4.1      |
| Net gains from sales of loans  | 141            | 504            | (363)     | (72.0)   |
| (Decrease) increase in fair value of servicing rights                                    | (17)           | 79             | (96)      | (121.5)  |
| Increase in cash surrender value of life insurance                                       | 99             | 109            | (10)      | (9.2)    |
| Net gain from premises and equipment   | 9              | 14             | (5)       | (35.7)   |
| Other operating income   | 335            | 311            | 24        | 7.7      |
| Total other operating income before realized gains on available-for-sale securities, net | \$3,887        | \$4,293        | (\$406)   | (9.5)    |

Table VI excludes realized gains on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table VI decreased \$406,000 or 9.5%, in the three months ended September 30, 2014 as compared to the three months ended September 30, 2013. The most significant variances include the following:

Net gains from sales of loans decreased \$363,000, or 72.0%. Since December 2009, the Corporation has sold a significant amount of residential mortgage loans into the secondary market through the MPF programs administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The decrease in revenue in 2014 reflects decreases in volume, including the impact of less refinancing activity.

The fair value of servicing rights associated with residential mortgage loans decreased \$17,000 in the three months ended September 30, 2014, as compared to an increase of \$79,000 in the same period of 2013. The average fair value of servicing rights, as a percentage of the total principal balance of loans serviced, increased by 0.10% in the third quarter 2013, mainly as a result of changes in prepayment assumptions. In comparison, there was little change in the average fair value of servicing rights in the third quarter 2014.

Trust and financial management revenue increased \$107,000, or 10.4%, as a result of growth in assets under management resulting from market appreciation as well as new business.

- Service charges on deposit accounts decreased \$82,000, or 6.0%, as the result of a decrease in overdraft fees.



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TABLE VII- COMPARISON OF NONINTEREST EXPENSE

(In Thousands)

|  | 9 Months Ended |          |         |         |
|--|----------------|----------|---------|---------|
|  | Sept. 30,      |          | \$      | %       |
|  | 2014           | 2013     | Change  | Change  |
| Salaries and wages                               | \$11,559       | \$10,771 | \$788   | 7.3     |
| Pensions and other employee benefits             | 3,563          | 3,165    | 398     | 12.6    |
| Occupancy expense, net                           | 2,002          | 1,859    | 143     | 7.7     |
| Furniture and equipment expense                  | 1,399          | 1,464    | (65)    | (4.4)   |
| FDIC Assessments                                 | 444            | 450      | (6)     | (1.3)   |
| Pennsylvania shares tax                          | 1,014          | 1,051    | (37)    | (3.5)   |
| Professional fees                                | 427            | 1,424    | (997)   | (70.0)  |
| Automated teller machine and interchange expense | 668            | 802      | (134)   | (16.7)  |
| Software subscriptions                           | 575            | 641      | (66)    | (10.3)  |
| Loss on prepayment of debt                       | 0              | 1,023    | (1,023) | (100.0) |
| Other operating expense                          | 4,256          | 4,056    | 200     | 4.9     |
| Total Other Expense                              | \$25,907       | \$26,706 | (\$799) | (3.0)   |

As shown in Table VII, total noninterest expense decreased \$799,000 or 3.0% in the first nine months of 2014 as compared to the first nine months of 2013. The decrease in expense included the loss on prepayment of debt of \$1,023,000 in 2013 compared to no loss in 2014. Excluding the loss on prepayment of debt in 2013, total noninterest expense increased \$224,000, or 0.9%. Other significant variances include the following:

Professional fees decreased \$997,000, or 70.0%, in the first nine months of 2014 as compared to the same period in 2013. The Corporation incurred professional fees in 2013 associated with consulting projects designed to identify sources of noninterest revenue and reductions of debit card and ATM processing fees.

Salaries and wages increased \$788,000, or 7.3%, primarily as a result of severance benefits incurred and paid in 2014.

Pensions and other employee benefits increased \$398,000, or 12.6%. Health care expense increased \$402,000, as the amount of claims incurred during the first nine months of 2014 was higher than in the same period in 2013. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party.

Occupancy expense increased \$143,000, or 7.7%. This increase includes increases in weather related expenses and in building maintenance costs.

Within other operating expense, collection expense increased \$168,000 during the nine months ended September 30, 2014 over the same period in 2013 as a result of increased real estate tax payments and building repair costs associated with loans.

Automated teller machine and interchange expenses decreased \$134,000, or 16.7%, mainly from benefits derived from the consulting project referred to above in 2013.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE VIII- COMPARISON OF NONINTEREST EXPENSE**

(In Thousands)

|  | 3 Months  |           |        |        |
|--|-----------|-----------|--------|--------|
|  | Ended     |           | \$     | %      |
|  | Sept. 30, | Sept. 30, | Change | Change |
|  | 2014      | 2013      |        |        |
| Salaries and wages                               | \$4,348   | \$3,536   | \$812  | 23.0   |
| Pensions and other employee benefits             | 1,091     | 876       | 215    | 24.5   |
| Occupancy expense, net                           | 646       | 626       | 20     | 3.2    |
| Furniture and equipment expense                  | 461       | 487       | (26)   | (5.3)  |
| FDIC Assessments                                 | 151       | 151       | 0      | 0.0    |
| Pennsylvania shares tax                          | 336       | 350       | (14)   | (4.0)  |
| Professional fees                                | 135       | 806       | (671)  | (83.3) |
| Automated teller machine and interchange expense | 239       | 218       | 21     | 9.6    |
| Software subscriptions                           | 184       | 209       | (25)   | (12.0) |
| Other operating expense                          | 1,445     | 1,351     | 94     | 7.0    |
| Total Other Expense                              | \$9,036   | \$8,610   | \$426  | 4.9    |

As shown in Table VIII, total noninterest expense increased \$426,000 or 4.9% in the three months ended September 30, 2014 as compared to the same period of 2013. Significant variances include the following:

Salaries and wages increased \$812,000, or 23.0%, primarily because of severance benefits incurred and paid in the third quarter 2014.

Professional fees decreased \$671,000, or 83.3%, in the three months ended September 30, 2014 as compared to the same period in 2013, as the third quarter 2013 included professional fee expense of \$724,000 for a consulting project designed to identify sources of noninterest revenue. There were no costs related to this project in 2014.

Pensions and other employee benefits increased \$215,000, or 24.5%. Health care expense increased \$254,000, as the amount of claims incurred during the three months ended September 30, 2014 was higher than in the same period in 2013. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party.

Within other expenses, collection expense increased \$77,000 during the three months ended September 30, 2014 over the same period in 2013 as a result of increased real estate tax payments and building repair costs associated with loans.

**FINANCIAL CONDITION**



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

Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition in 2014.

#### 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 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

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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 \$7,449,000 at September 30, 2014, down from \$8,663,000 at December 31, 2013. As shown in Table X, the specific allowance on impaired loans totaled \$966,000 at September 30, 2014, which was \$1,367,000 lower than the total specific allowance at December 31, 2013. The decrease in the specific allowances on impaired loans includes a charge-off of \$1,486,000 related to one commercial loan relationship for which a specific allowance of \$1,552,000 had been established at December 31, 2013. Table X also shows the collectively determined component of the allowance for commercial loans was \$211,000 higher at September 30, 2014 than at December 31, 2013. The collectively determined allowance for the commercial segment increased mainly because the net charge-off percentage used to determine a portion of the collectively determined allowance was higher at September 30, 2014 as compared to the percentage used throughout 2013. (The Corporation used net charge-offs as a percentage of average outstanding loans for the previous thirty-six months to estimate a portion of the collectively determined allowance at both September 30, 2014 and December 31, 2013.) This increase was partially offset by the effects on collectively determined allowances of lower loan balances at September 30, 2014 as compared to December 31, 2013.

The provision (credit) for loan losses by segment in the three-month and nine-month periods ended September 30, 2014 and 2013 is as follows:

| (In Thousands)       | 3 Months Ended    |                   | 9 Months Ended    |                   |
|----------------------|-------------------|-------------------|-------------------|-------------------|
|                      | Sept. 30,<br>2014 | Sept. 30,<br>2013 | Sept. 30,<br>2014 | Sept. 30,<br>2013 |
| Residential mortgage | \$62              | \$59              | \$111             | \$444             |
| Commercial           | 161               | 189               | 295               | 85                |
| Consumer             | (5)               | (9)               | (50)              | 2                 |
| Unallocated          | 0                 | 0                 | (3)               | (43)              |
| <b>Total</b>         | <b>\$218</b>      | <b>\$239</b>      | <b>\$353</b>      | <b>\$488</b>      |

In the third quarter 2014, the total provision for loan losses was \$218,000 compared to the third quarter 2013 total of \$239,000. The provision related to commercial loans decreased \$28,000. The decrease in the provision related to the commercial segment resulted from a decrease in the qualitative factors used in determining the collective portions of the allowance for loan losses in the third quarter 2014.

The provision for loan losses related to the residential mortgage segment for the nine months ended September 30, 2014 totaled \$111,000, and reflected a slight increase in loan balances and the historical loss factors applied in calculating the collectively evaluated portion of the allowance for loan losses at September 30, 2014 in comparison to loan balances and to the historical loss factors applied at December 31, 2013. In comparison, the \$444,000 provision for loan losses for the residential mortgage segment in the first nine months of 2013 included an increase in the

collectively evaluated portion of the allowance of \$198,000, reflecting an increase in the net charge-off percentage used in the calculations for that period, and a \$181,000 increase in the allowance on impaired loans. The provision for loan losses for commercial loans for the nine months ended September 30, 2014 of \$295,000 reflected an increase in the collectively determined portion of the allowance for loan losses as a result of an increase in net charge-off percentages used in the calculations for the period. The provision related to commercial loans in the first nine months of 2013 included a lower aggregate amount of charges for impaired commercial loans, partially offset by an increase in the collectively evaluated portion of the allowance. In the first nine months of 2013, net charge-offs of commercial loans totaled \$113,000 while the total specific allowances on impaired loans decreased \$61,000.

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). Table XI shows total impaired loans of \$14,094,000 at September 30, 2014, down from the corresponding amount at December 31, 2013 of \$16,321,000. Though down from year-end 2013, the amount of impaired loans (as well as nonperforming loans as reflected in the table) at September 30, 2014 is significantly higher than it was from 2009 through 2012. The increase in impaired and nonperforming loans at September 30, 2014 and December 31, 2013 as compared to the other periods presented reflected the classification as nonperforming of two large commercial loan relationships with outstanding balances totaling \$7,067,000 at September 30, 2014 and \$7,599,000 at December 31, 2013. The total of the specific allowance for loan losses on those two relationships amounted to \$211,000 at September 30, 2014 and \$1,624,000 at December 31, 2013. As described in the following paragraph, during the second quarter 2014, a charge-off of \$1,486,000 was made related to one of these

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commercial loan relationships resulting in the decrease in the specific allowance as well as total impaired loans with a valuation allowance.

As shown in Table XI, loans classified as TDRs increased to \$8,006,000 at September 30, 2014 from \$4,175,000 at December 31, 2013. This increase relates mainly to one commercial borrower. The Corporation entered into a forbearance agreement with this commercial borrower which includes a reduction in monthly payment amounts over a fifteen-month period. At the end of the fifteen-month period, the monthly payment amounts would revert to the original amounts, unless the forbearance agreement is extended or the payment requirements are otherwise modified. The Corporation recorded a charge-off of \$1,486,000 in the second quarter 2014 as a result of these modifications, as the payment amounts based on the forbearance agreement are not sufficient to fully amortize the contractual amount of principal outstanding on the loans. The amount of the charge-off was determined based on the excess of the contractual principal due over the present value of the payment amounts provided for in the forbearance agreement, assuming the revised payment amounts would continue until maturity, at the contractual interest rates.

Table XI reflects a lower amount of total loans past due 30-89 days and still accruing interest at September 30, 2014 of \$5,458,000 as compared to the December 31, 2013 total of \$8,305,000, mainly due to a lower amount of past due residential mortgage loans. Also, total loans past due 90 days or more and still accruing interest was down at September 30, 2014 to \$2,602,000 from \$3,131,000. As part of its normal quarterly procedures, management reviewed loans past due 90 days or more at September 30, 2014, and determined the loans remaining in accrual status to be well secured and in the process of collection. Each period presented in Table XI includes a few large commercial relationships that have required significant monitoring and workout efforts. As a result, a limited number of relationships may significantly impact the total amount of allowance required on impaired loans, and may significantly impact the amount of total charge-offs reported in any one period.

Management believes it has been conservative in its decisions concerning identification of impaired loans, estimates of loss, and nonaccrual status; however, the actual losses realized from these relationships could vary materially from the allowances calculated as of September 30, 2014. Management continues to closely monitor its commercial loan relationships for possible credit losses, and will adjust its estimates of loss and decisions concerning nonaccrual status, if appropriate.

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

**TABLE IX - ANALYSIS OF THE ALLOWANCE FOR  
LOAN LOSSES**  
(In Thousands)

9 Months Ended  
Sept. 30, Sept. 30, Years Ended December 31,

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|   | 2014    | 2013    | 2013    | 2012    | 2011    | 2010    | 2009    |
|---|---------|---------|---------|---------|---------|---------|---------|
| Balance, beginning of year              | \$8,663 | \$6,857 | \$6,857 | \$7,705 | \$9,107 | \$8,265 | \$7,857 |
| Charge-offs:                            |         |         |         |         |         |         |         |
| Residential mortgage                    | (96)    | (76)    | (95)    | (552)   | (100)   | (340)   | (146)   |
| Commercial                              | (1,715) | (459)   | (459)   | (498)   | (1,189) | (91)    | (39)    |
| Consumer                                | (70)    | (84)    | (117)   | (171)   | (157)   | (188)   | (293)   |
| Total charge-offs                       | (1,881) | (619)   | (671)   | (1,221) | (1,446) | (619)   | (478)   |
| Recoveries:                             |         |         |         |         |         |         |         |
| Residential mortgage                    | 13      | 11      | 24      | 18      | 3       | 55      | 8       |
| Commercial                              | 264     | 346     | 348     | 8       | 255     | 113     | 77      |
| Consumer                                | 37      | 47      | 58      | 59      | 71      | 102     | 121     |
| Total recoveries                        | 314     | 404     | 430     | 85      | 329     | 270     | 206     |
| Net charge-offs                         | (1,567) | (215)   | (241)   | (1,136) | (1,117) | (349)   | (272)   |
| Provision (credit) for loan losses      | 353     | 488     | 2,047   | 288     | (285)   | 1,191   | 680     |
| Balance, end of period                  | \$7,449 | \$7,130 | \$8,663 | \$6,857 | \$7,705 | \$9,107 | \$8,265 |
| Net charge-offs as a % of average loans | 0.25%   | 0.03%   | 0.04%   | 0.16%   | 0.16%   | 0.05%   | 0.04%   |

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

|                                | Sept. 30, | As of December 31, |         |         |         |         |
|--------------------------------|-----------|--------------------|---------|---------|---------|---------|
|                                | 2014      | 2013               | 2012    | 2011    | 2010    | 2009    |
| ASC 310 - Impaired loans       | \$966     | \$2,333            | \$623   | \$1,126 | \$2,288 | \$1,126 |
| ASC 450 - Collective segments: |           |                    |         |         |         |         |
| Commercial                     | 2,794     | 2,583              | 2,594   | 2,811   | 3,047   | 2,677   |
| Residential mortgage           | 3,184     | 3,156              | 3,011   | 3,130   | 3,227   | 3,859   |
| Consumer                       | 110       | 193                | 188     | 204     | 232     | 281     |
| Unallocated                    | 395       | 398                | 441     | 434     | 313     | 322     |
| Total Allowance                | \$7,449   | \$8,663            | \$6,857 | \$7,705 | \$9,107 | \$8,265 |

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

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

| (In Thousands)  | As of     |                    |          |         |          |         |
|---|-----------|--------------------|----------|---------|----------|---------|
|   | Sept. 30, | As of December 31, |          |         |          |         |
|   | 2014      | 2013               | 2012     | 2011    | 2010     | 2009    |
| Impaired loans with a valuation allowance               | \$4,059   | \$9,889            | \$2,710  | \$3,433 | \$5,457  | \$2,690 |
| Impaired loans without a valuation allowance            | 10,035    | 6,432              | 4,719    | 4,431   | 3,191    | 3,257   |
| Total impaired loans                                    | \$14,094  | \$16,321           | \$7,429  | \$7,864 | \$8,648  | \$5,947 |
| Total loans past due 30-89 days and still accruing      | \$5,458   | \$8,305            | \$7,756  | \$7,898 | \$7,125  | \$9,445 |
| Nonperforming assets:                                   |           |                    |          |         |          |         |
| Total nonaccrual loans                                  | \$13,722  | \$14,934           | \$7,353  | \$7,197 | \$10,809 | \$9,092 |
| Total loans past due 90 days or more and still accruing | 2,602     | 3,131              | 2,311    | 1,267   | 727      | 31      |
| Total nonperforming loans                               | 16,324    | 18,065             | 9,664    | 8,464   | 11,536   | 9,123   |
| Foreclosed assets held for sale (real estate)           | 1,888     | 892                | 879      | 1,235   | 537      | 873     |
| Total nonperforming assets                              | \$18,212  | \$18,957           | \$10,543 | \$9,699 | \$12,073 | \$9,996 |
| Loans subject to troubled debt restructurings (TDRs):   |           |                    |          |         |          |         |
| Performing  | \$1,834   | \$3,267            | \$906    | \$1,064 | \$645    | \$326   |
| Nonperforming   | 6,172     | 908                | 1,155    | 2,413   | 0        | 0       |
| Total TDRs  | \$8,006   | \$4,175            | \$2,061  | \$3,477 | \$645    | \$326   |

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|   |        |        |        |        |        |        |
|---|--------|--------|--------|--------|--------|--------|
| Total nonperforming loans as a % of loans               | 2.59%  | 2.80%  | 1.41%  | 1.19%  | 1.58%  | 1.27%  |
| Total nonperforming assets as a % of assets             | 1.45%  | 1.53%  | 0.82%  | 0.73%  | 0.92%  | 0.76%  |
| Allowance for loan losses as a % of total loans         | 1.18%  | 1.34%  | 1.00%  | 1.09%  | 1.25%  | 1.15%  |
| Allowance for loan losses as a % of nonperforming loans | 45.63% | 47.95% | 70.95% | 91.03% | 78.94% | 90.60% |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE XII - SUMMARY OF LOANS BY TYPE****Summary of Loans by Type**

| (In Thousands)                            | Sept. 30, As of December 31, |           |           |           |           |           |
|---|------------------------------|-----------|-----------|-----------|-----------|-----------|
|   | 2014                         | 2013      | 2012      | 2011      | 2010      | 2009      |
| <b>Residential mortgage:</b>              |                              |           |           |           |           |           |
| Residential mortgage loans - first liens  | \$290,943                    | \$299,831 | \$311,627 | \$331,015 | \$333,012 | \$340,268 |
| Residential mortgage loans - junior liens | 21,843                       | 23,040    | 26,748    | 28,851    | 31,590    | 35,734    |
| Home equity lines of credit               | 35,975                       | 34,530    | 33,017    | 30,037    | 26,853    | 23,577    |
| 1-4 Family residential construction       | 16,895                       | 13,909    | 12,842    | 9,959     | 14,379    | 11,452    |
| Total residential mortgage                | 365,656                      | 371,310   | 384,234   | 399,862   | 405,834   | 411,031   |
| <b>Commercial:</b>                        |                              |           |           |           |           |           |
| Commercial loans secured by real estate   | 144,410                      | 147,215   | 158,413   | 156,388   | 167,094   | 163,483   |
| Commercial and industrial                 | 50,615                       | 42,387    | 48,442    | 57,191    | 59,005    | 49,753    |
| Political subdivisions                    | 14,823                       | 16,291    | 31,789    | 37,620    | 36,480    | 37,598    |
| Commercial construction and land          | 9,069                        | 17,003    | 28,200    | 23,518    | 24,004    | 15,264    |
| Loans secured by farmland                 | 8,542                        | 10,468    | 11,403    | 10,949    | 11,353    | 11,856    |
| Multi-family (5 or more) residential      | 9,092                        | 10,985    | 6,745     | 6,583     | 7,781     | 8,338     |
| Agricultural loans                        | 3,284                        | 3,251     | 3,053     | 2,987     | 3,472     | 3,848     |
| Other commercial loans                    | 13,620                       | 14,631    | 362       | 552       | 392       | 638       |
| Total commercial                          | 253,455                      | 262,231   | 288,407   | 295,788   | 309,581   | 290,778   |
| Consumer                                  | 10,298                       | 10,762    | 11,269    | 12,665    | 14,996    | 19,202    |
| Total                                     | 629,409                      | 644,303   | 683,910   | 708,315   | 730,411   | 721,011   |
| Less: allowance for loan losses           | (7,449)                      | (8,663)   | (6,857)   | (7,705)   | (9,107)   | (8,265)   |
| Loans, net                                | \$621,960                    | \$635,640 | \$677,053 | \$700,610 | \$721,304 | \$712,746 |

**LIQUIDITY**

Liquidity is the ability to quickly raise cash at a reasonable cost. An adequate liquidity position permits the Corporation to pay creditors, compensate for unforeseen deposit fluctuations and fund unexpected loan demand. At September 30, 2014, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$32,387,000.

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 \$26,078,000 at September 30, 2014.

The Corporation's outstanding, available, and total credit facilities at September 30, 2014 and December 31, 2013 are as follows:

| <b>(In Thousands)</b>                | <b>Outstanding</b>    |                      | <b>Available</b>      |                      | <b>Total Credit</b>   |                      |
|--------------------------------------|-----------------------|----------------------|-----------------------|----------------------|-----------------------|----------------------|
|                                      | <b>Sept. 30, 2014</b> | <b>Dec. 31, 2013</b> | <b>Sept. 30, 2014</b> | <b>Dec. 31, 2013</b> | <b>Sept. 30, 2014</b> | <b>Dec. 31, 2013</b> |
| Federal Home Loan Bank of Pittsburgh | \$12,131              | \$34,335             | \$311,633             | \$304,875            | \$323,764             | \$339,210            |
| Federal Reserve Bank Discount Window | 0                     | 0                    | 25,189                | 26,078               | 25,189                | 26,078               |
| Other correspondent banks            | 0                     | 0                    | 45,000                | 45,000               | 45,000                | 45,000               |
| Total credit facilities              | \$12,131              | \$34,335             | \$381,822             | \$375,953            | \$393,953             | \$410,288            |

At September 30, 2014, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of long-term borrowings with a total amount of \$12,131,000. At December 31, 2013, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh included a short-term borrowing of

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\$20,000,000, long-term borrowings with a total amount of \$12,338,000 and a letter of credit in the amount of \$1,997,000. Additional information regarding borrowed funds is included in Note 8 of the unaudited consolidated financial statements.

Additionally, the Corporation uses repurchase agreements placed with brokers to borrow funds secured by investment assets and “RepoSweep” arrangements to borrow funds from commercial banking customers on an overnight basis. If required to raise cash in an emergency situation, the Corporation could sell available-for-sale securities to meet its obligations. At September 30, 2014, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was \$253,088,000.

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

**STOCKHOLDERS’ EQUITY AND CAPITAL ADEQUACY**

The Corporation and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning capital ratios at September 30, 2014 and December 31, 2013 are presented below. Management believes, as of September 30, 2014 and December 31, 2013, that the Corporation and C&N Bank meet all capital adequacy requirements to which they are subject.

| (Dollars in Thousands)                  | Actual    |        | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|---|-----------|--------|-----------------------------|-------|--|-------|
|   | Amount    | Ratio  | Amount                      | Ratio | Amount   | Ratio |
| <b>September 30, 2014:</b>              |           |        |                             |       |  |       |
| Total capital to risk-weighted assets:  |           |        |                             |       |  |       |
| Consolidated                            | \$179,389 | 27.42% | \$52,348                    | 38%   | n/a  | n/a   |
| C&N Bank                                | 154,986   | 23.98% | 51,699                      | 38%   | \$64,624   | 310%  |
| Tier 1 capital to risk-weighted assets: |           |        |                             |       |  |       |
| Consolidated                            | 170,704   | 26.09% | 26,174                      | 34%   | n/a  | n/a   |
| C&N Bank                                | 147,508   | 22.83% | 25,850                      | 34%   | 38,774   | 36%   |
| Tier 1 capital to average assets:       |           |        |                             |       |  |       |
| Consolidated                            | 170,704   | 13.78% | 49,569                      | 34%   | n/a  | n/a   |
| C&N Bank                                | 147,508   | 12.04% | 49,017                      | 34%   | 61,271   | 35%   |
| <b>December 31, 2013:</b>               |           |        |                             |       |  |       |
| Total capital to risk-weighted assets:  |           |        |                             |       |  |       |
| Consolidated                            | \$177,693 | 26.60% | \$53,449                    | 38%   | n/a  | n/a   |

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|   |         |        |        |     |          |      |
|---|---------|--------|--------|-----|----------|------|
| C&N Bank                                | 162,610 | 24.65% | 52,783 | 38% | \$65,979 | 310% |
| Tier 1 capital to risk-weighted assets: |         |        |        |     |          |      |
| Consolidated                            | 168,039 | 25.15% | 26,724 | 34% | n/a      | n/a  |
| C&N Bank                                | 154,323 | 23.39% | 26,392 | 34% | 39,588   | 36%  |
| Tier 1 capital to average assets:       |         |        |        |     |          |      |
| Consolidated                            | 168,039 | 13.78% | 48,783 | 34% | n/a      | n/a  |
| C&N Bank                                | 154,323 | 12.77% | 48,348 | 34% | 60,435   | 35%  |

Effective July 17, 2014, the Corporation terminated its existing treasury stock repurchase programs and approved a new treasury stock repurchase program. Under the new program, the Corporation is authorized to repurchase up to 622,500 shares of the Corporation's common stock, or approximately 5% of the Corporation's issued and outstanding shares at July 16, 2014. As permitted by securities laws and other legal requirements and subject to market conditions and other factors, purchases under the new program may be made from time to time in the open market at prevailing prices, or through privately negotiated transactions.

Consistent with previous programs, the Board of Directors' July 17, 2014 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

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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. Through September 30, 2014, 129,000 shares had been repurchased at a cost of \$2,464,000.

Management expects the Corporation and C&N Bank to maintain capital levels that exceed the regulatory standards for well-capitalized institutions for the next 12 months and for the foreseeable future. Planned capital expenditures are not expected to have a significantly detrimental effect on capital ratios.

Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. 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.

The Corporation's total stockholders' equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in Accumulated Other Comprehensive Income (Loss) within stockholders' equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains on available-for-sale securities, net of deferred income tax, amounted to \$3,940,000 at September 30, 2014 and (\$1,004,000) at December 31, 2013. 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 September 30, 2014.

Stockholders' equity is also affected by the underfunded or overfunded status of defined benefit pension and postretirement plans. The balance in Accumulated Other Comprehensive Income related to defined benefit plans, net of deferred income tax, was \$97,000 at September 30, 2014 and \$11,000 at December 31, 2013.

**NEW CAPITAL RULE**

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



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A summarized comparison of the existing capital requirements with requirements under the new rule is as follows:

|  | <b>Current General<br/>Risk-Based<br/>Capital Rule</b> | <b>New Capital Rule</b>                                  |
|--|--|--|
| <b>Minimum regulatory capital ratios:</b>  |  |  |
| Common equity tier 1 capital/<br>risk-weighted assets (RWA)                      | N/A  | 4.5%   |
| Tier 1 capital / RWA   | 4%   | 6%   |
| Total capital / RWA  | 8%   | 8%   |
| Tier 1 capital / Average assets<br>(Leverage ratio)                              | 4%   | 4%   |
| <b>Capital buffers:</b>  |  |  |
| Capital conservation buffer  | N/A  | 2.5% of RWA; composed of<br>common equity tier 1 capital |
| <b>Prompt correction action levels -<br/>Common equity tier 1 capital ratio:</b> |  |  |
| Well capitalized   | N/A  | 36.5%  |
| Adequately capitalized   | N/A  | 34.5%  |
| Undercapitalized   | N/A  | <4.5%  |
| Significantly undercapitalized   | N/A  | <3%  |
| <b>Prompt correction action levels -<br/>Tier 1 capital ratio:</b>               |  |  |
| Well capitalized   | 36%  | 38%  |
| Adequately capitalized   | 34%  | 36%  |
| Undercapitalized   | <4%  | <6%  |
| Significantly undercapitalized   | <3%  | <4%  |
| <b>Prompt correction action levels -<br/>Total capital ratio:</b>                |  |  |
| Well capitalized   | 310%   | 310%   |
| Adequately capitalized   | 38%  | 38%  |
| Undercapitalized   | <8%  | <8%  |
| Significantly undercapitalized   | <6%  | <6%  |
| <b>Prompt correction action levels -<br/>Leverage ratio:</b>                     |  |  |
| Well capitalized   | 35%  | 35%  |
| Adequately capitalized   | 34%  | 34%  |
| Undercapitalized   | <4%  | <4%  |
| Significantly undercapitalized   | <3%  | <3%  |

**Prompt correction action levels -**

**Critically undercapitalized:**

|                                 |            |            |
|---------------------------------|------------|------------|
| Tangible equity to total assets | $\leq 2\%$ | $\leq 2\%$ |
|---------------------------------|------------|------------|

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

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

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

| <b>Capital Conservation Buffer</b><br><b>(as a % of risk-weighted assets)</b> | <b>Maximum Payout</b><br><b>(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%   |

**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.

Comprehensive Income totaled \$2,888,000 for the three months ended September 30, 2014 as compared to \$4,377,000 in the third quarter 2013. In the third quarter 2014, Comprehensive Income included: (1) Net Income of \$4,267,000, which was \$422,000 lower than in the third quarter 2013; and (2) Other Comprehensive Loss from unrealized gains on available-for-sale securities, net of deferred income tax, of \$1,379,000 as compared to Other Comprehensive Loss of \$312,000 in the third quarter 2013. For the nine months ended September 30, 2014, Comprehensive Income totaled \$17,748,000 as compared to \$5,734,000 for the nine months ended September 30, 2013. In the nine months ended September 30, 2014, Comprehensive Income included: (1) Net Income of \$12,718,000, which was \$1,651,000 lower than in the first nine months of 2013; (2) Other Comprehensive Income from unrealized gains on available-for-sale securities, net of

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deferred income tax, of \$4,944,000 as compared to Other Comprehensive Loss of \$9,048,000 in the first nine months of 2013; and (3) Other Comprehensive Income from defined benefit plans of \$86,000 as compared to \$413,000 in the first nine months of 2013. 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.

**INCOME TAXES**

The effective income tax rate was approximately 25% of pre-tax income for the three-month and nine-month periods ended September 30, 2014 and 2013. The provision for income tax for interim periods is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At September 30, 2014, the net deferred tax asset was \$2,673,000, down from \$6,344,000 at December 31, 2013. At September 30, 2014, the deferred tax liability associated with unrealized gains on available-for-sale securities was \$2,121,000 as compared to a deferred tax asset on the unrealized loss on available-for-sale securities at December 31, 2013 of \$541,000. Also, the deferred tax assets related to the credit for alternative minimum tax paid and the allowance for loan losses decreased by a total of \$1,257,000 based on activity for the nine months ended September 30, 2014.

The Corporation regularly reviews deferred tax assets for recoverability based on history of earnings, expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. Management believes the recorded net deferred tax asset at September 30, 2014 is fully realizable; however, if management determines the Corporation will be unable to realize all or part of the net deferred tax asset, the Corporation would adjust the deferred tax asset, which would negatively impact earnings.

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

**INFLATION**

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in short-term interest rates. Beginning in September 2007, in response to concerns about weakness in the U.S. economy, the Federal Reserve lowered the fed funds target rate numerous times; in December 2008, it established a target range of 0% to 0.25%, which it has maintained through the first several months of 2014. Also, the Federal Reserve has injected massive amounts of liquidity into the nation's monetary system through a variety of programs. The Federal Reserve has purchased large amounts of securities in an effort to keep interest rates low and stimulate economic growth. Although the Federal Reserve reduced the amount of securities it purchased beginning in late 2013, highly accommodative monetary policy in the form of low short-term interest rates is expected until at least mid-2015.

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

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

**INTEREST RATE RISK**

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

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

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage-backed securities and call activity on other investment securities. Actual results could vary significantly from these estimates, which could result in significant differences in the calculations of projected changes in net interest income and market value of portfolio equity. Also, the model does not make estimates related to changes in the composition of the deposit portfolio that could occur due to rate competition, and the table does not necessarily reflect changes that management would make to realign the portfolio as a result of changes in interest rates.

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

Table XIII, which follows this discussion, is based on the results of calculations performed using the simulation model as of July 31, 2014 and December 31, 2013. 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.

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TABLE XIII - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES

July 31, 2014 Data  
(In Thousands)

## Period Ending July 31, 2015

| 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                           | \$53,772           | \$22,828            | \$30,944                     | -22.2%          | 25.0%             |
| +300                           | 51,572             | 17,998              | 33,574                       | -15.6%          | 20.0%             |
| +200                           | 49,358             | 13,411              | 35,947                       | -9.6%           | 15.0%             |
| +100                           | 47,027             | 9,177               | 37,850                       | -4.8%           | 10.0%             |
| 0                              | 44,723             | 4,957               | 39,766                       | 0.0%            | 0.0%              |
| -100                           | 42,221             | 4,772               | 37,449                       | -5.8%           | 10.0%             |
| -200                           | 40,614             | 4,768               | 35,846                       | -9.9%           | 15.0%             |
| -300                           | 39,761             | 4,768               | 34,993                       | -12.0%          | 20.0%             |
| -400                           | 39,648             | 4,768               | 34,880                       | -12.3%          | 25.0%             |

## Market Value of Portfolio Equity at July 31, 2014

| Basis Point<br>Change in Rates | Present<br>Value<br>Equity | Present<br>Value<br>% Change | Present<br>Value<br>Risk Limit |
|--------------------------------|----------------------------|------------------------------|--------------------------------|
| +400                           | \$166,515                  | -27.0%                       | 50.0%                          |
| +300                           | 180,072                    | -21.0%                       | 45.0%                          |
| +200                           | 195,957                    | -14.1%                       | 35.0%                          |
| +100                           | 211,387                    | -7.3%                        | 25.0%                          |
| 0                              | 228,002                    | 0.0%                         | 0.0%                           |
| -100                           | 230,088                    | 0.9%                         | 25.0%                          |
| -200                           | 230,714                    | 1.2%                         | 35.0%                          |
| -300                           | 249,376                    | 9.4%                         | 45.0%                          |
| -400                           | 285,811                    | 25.4%                        | 50.0%                          |

December 31, 2013 Data  
(In Thousands)

## Period Ending December 31, 2014

| 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                           | \$53,993           | \$23,975            | \$30,018                     | -24.4%          | 25.0%             |
| +300                           | 51,748             | 18,975              | 32,773                       | -17.4%          | 20.0%             |
| +200                           | 49,496             | 14,091              | 35,405                       | -10.8%          | 15.0%             |
| +100                           | 47,146             | 9,552               | 37,594                       | -5.3%           | 10.0%             |
| 0                              | 44,821             | 5,123               | 39,698                       | 0.0%            | 0.0%              |
| -100                           | 42,432             | 4,897               | 37,535                       | -5.4%           | 10.0%             |
| -200                           | 40,747             | 4,895               | 35,852                       | -9.7%           | 15.0%             |

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|             |        |       |        |        |       |
|-------------|--------|-------|--------|--------|-------|
| <b>-300</b> | 40,059 | 4,895 | 35,164 | -11.4% | 20.0% |
| <b>-400</b> | 39,968 | 4,895 | 35,073 | -11.7% | 25.0% |

**Market Value of Portfolio Equity at December 31, 2013**

| <b>Basis Point<br/>Change in Rates</b> | <b>Present<br/>Value<br/>Equity</b> | <b>Present<br/>Value<br/>% Change</b> | <b>Present<br/>Value<br/>Risk Limit</b> |
|--|-------------------------------------|---------------------------------------|---|
| <b>+400</b>                            | \$161,652                           | -28.5%                                | 50.0%                                   |
| <b>+300</b>                            | 175,176                             | -22.6%                                | 45.0%                                   |
| <b>+200</b>                            | 192,513                             | -14.9%                                | 35.0%                                   |
| <b>+100</b>                            | 209,428                             | -7.4%                                 | 25.0%                                   |
| <b>0</b>                               | 226,204                             | 0.0%                                  | 0.0%                                    |
| <b>-100</b>                            | 230,189                             | 1.8%                                  | 25.0%                                   |
| <b>-200</b>                            | 233,902                             | 3.4%                                  | 35.0%                                   |
| <b>-300</b>                            | 250,451                             | 10.7%                                 | 45.0%                                   |
| <b>-400</b>                            | 282,994                             | 25.1%                                 | 50.0%                                   |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****EQUITY SECURITIES RISK**

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

Equity securities held as of September 30, 2014 and December 31, 2013 are presented in Table XIV. Table XIV presents quantitative data concerning the effects of a decline in fair value of the Corporation's equity securities of 10% or 20%. The data in Table XIV does not reflect the effects of any appreciation in value that may occur, nor does it present the Corporation's maximum exposure to loss on equity securities, which would be 100% of their fair value as of September 30, 2014.

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

|  | <b>Sept. 30, Dec. 31,</b> |             |
|--|---------------------------|-------------|
|  | <b>2014</b>               | <b>2013</b> |
| Cost                                     | \$5,605                   | \$6,038     |
| Fair Value                               | 8,353                     | 8,924       |
| Hypothetical 10% Decline In Market Value | (835)                     | (892)       |
| Hypothetical 20% Decline In Market Value | (1,671)                   | (1,785)     |

**ITEM 4. CONTROLS AND PROCEDURES**

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



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

On May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued an updated version of its Internal Control – Integrated Framework (2013 Framework). Originally issued in 1992 (1992 Framework), the framework helps organizations design, implement and evaluate the effectiveness of internal control concepts and simplify their use and application. The 1992 Framework remains available during the transition period, which extends to December 15, 2014, after which time COSO will consider it as superseded by the 2013 Framework. As of September 30, 2014, the Corporation continued to utilize the 1992 Framework.

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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**

Except for the risk factor labeled "Biggert-Waters Flood Insurance Act," which is discussed in the following paragraphs, there have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation's Form 10-K filed February 20, 2014.

The Corporation's Form 10-K for the year ended December 31, 2013 included the description of a risk factor related to significantly increasing costs of flood insurance for borrowers as a result of changes in the National Flood Insurance Program resulting from the Biggert-Waters Flood Insurance Act. In March 2014, Congress passed, and President Obama signed, a new law titled the Homeowner Flood Insurance Affordability Act. The new law repeals and modifies certain provisions of the Biggert-Waters Flood Insurance Act, including (among other changes) provision of a limit on annual rate increases of 18% and elimination of a sales trigger that had required home buyers to pay the full risk rate for flood insurance when a home was sold.

Although the Homeowner Flood Insurance Affordability Act defers some of the rate increases, the intent of the new law remains consistent with the intent of the Biggert-Waters Flood Insurance Act to phase out or reduce the federal government's subsidization of the cost of flood insurance policies. Accordingly, the risk continues to exist that reductions in collateral values associated with properties located in flood zones that secure some of the Corporation's residential and commercial loans could occur, and some borrowers may become unable or unwilling to make their loan payments as a result of the increased costs of flood insurance. These potential results could have a material effect on the Corporation's financial condition, results of operations or liquidity.

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

Issuer Purchases of Equity Securities

On May 19, 2011, the Corporation announced the Board of Directors had authorized repurchases of outstanding common stock, up to a total of \$1 million, in open market or privately negotiated transactions. At its September 22,

2011 meeting, the Board of Directors authorized repurchases of outstanding common stock in open market or privately negotiated transactions, up to a total of \$1 million, as an addition to the stock repurchase program previously announced on May 19, 2011. The Board of Directors' authorizations provided that: (1) the treasury stock repurchase programs became effective when publicly announced and would 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 programs would 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.

Effective July 17, 2014, the Corporation terminated its existing treasury stock repurchase programs (described immediately above) and approved a new treasury stock repurchase program. Under the new program, the Corporation is authorized to repurchase up to 622,500 shares of the Corporation's common stock, or approximately 5% of the Corporation's issued and outstanding shares at July 16, 2014. As permitted by securities laws and other legal requirements and subject to market conditions and other factors, purchases under the new program may be made from time to time in the open market at prevailing prices, or through privately negotiated transactions. As of September 30, 2014, the maximum number of additional shares the Corporation may repurchase under this program is 493,500.

Consistent with previous programs, the Board of Directors' July 17, 2014 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

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limitation, pursuant to the Corporation's Dividend Reinvestment and Stock Purchase Plan and its equity compensation program.

The following table sets forth a summary of the purchases by the Corporation, on the open market, of its equity securities during the third quarter 2014:

| <b>Period</b>          | <b>Total Number of Shares Purchased</b> | <b>Average Price Paid per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b> | <b>Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs</b> |
|------------------------|---|-------------------------------------|---|---|
| July 1 - 31, 2014      | 30,400                                  | \$18.86                             | 30,400  | 592,100   |
| August 1 - 31, 2014    | 68,500                                  | \$19.08                             | 98,900  | 523,600   |
| September 1 - 30, 2014 | 30,100                                  | \$19.39                             | 129,000   | 493,500   |

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

None

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**Item 6. Exhibits**

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

|                                 |                |
|---------------------------------|----------------|
| 32. Section 1350 certifications | Filed herewith |
| 99. Additional exhibits         | Not applicable |
| 100. XBRL-related documents     | Not applicable |
| 101. Interactive data file      | Filed herewith |

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**SIGNATURES**

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

CITIZENS & NORTHERN CORPORATION

November 7, 2014 By: /s/ Mark A. Hughes

Date Interim President and Chief Executive Officer

November 7, 2014 By: /s/ Anthony J. Peluso

Date Interim Treasurer and Chief Financial Officer