

CITIZENS & NORTHERN CORP

Form 10-Q

November 01, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

FORM 10-Q

**(Mark One)**

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

For the quarterly period ended **September 30, 2018**

or

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

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

**Commission file number: 000-16084**

**CITIZENS & NORTHERN CORPORATION**

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA 23-2451943

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

90-92 MAIN STREET, WELLSBORO, PA 16901

(Address of principal executive offices) (Zip code)

570-724-3411

(Registrant's telephone number including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes x No "

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

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

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

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

Yes " No x

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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) 12,298,357 Shares Outstanding on October 29, 2018

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

**CITIZENS & NORTHERN CORPORATION**

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

	September 30, 2018	December 31, 2017
<b>ASSETS</b>		
Cash and due from banks:		
Noninterest-bearing	\$ 20,978	\$ 25,664
Interest-bearing	17,363	14,580
Total cash and due from banks	38,341	40,244
Available-for-sale debt securities, at fair value	358,706	355,937
Marketable equity security	941	971
Loans held for sale	551	765
Loans receivable	822,532	815,713
Allowance for loan losses	(8,815)	(8,856)
Loans, net	813,717	806,857
Bank-owned life insurance	18,935	20,083
Accrued interest receivable	4,279	4,048
Bank premises and equipment, net	14,824	15,432
Foreclosed assets held for sale	2,678	1,598
Deferred tax asset, net	5,122	3,289
Intangible assets - Goodwill and core deposit intangibles	11,951	11,954
Other assets	15,394	15,781
<b>TOTAL ASSETS</b>	<b>\$ 1,285,439</b>	<b>\$ 1,276,959</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 260,961	\$ 241,214
Interest-bearing	782,986	767,235
Total deposits	1,043,947	1,008,449
Short-term borrowings	8,421	61,766
Long-term borrowings	32,985	9,189
Accrued interest and other liabilities	10,099	9,112
<b>TOTAL LIABILITIES</b>	<b>1,095,452</b>	<b>1,088,516</b>

**STOCKHOLDERS' EQUITY**

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Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; no shares issued	0	0
Common stock, par value \$1.00 per share; authorized 20,000,000 shares; issued 12,655,171; outstanding 12,297,274 at September 30, 2018 and 12,214,525 December 31, 2017	12,655	12,655
Paid-in capital	72,197	72,035
Retained earnings	120,283	113,608
Treasury stock, at cost; 357,897 shares at September 30, 2018 and 440,646 shares at December 31, 2017	(6,780 )	(8,348 )
Accumulated other comprehensive loss	(8,368 )	(1,507 )
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>189,987</b>	<b>188,443</b>
<b>TOTAL LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>	<b>\$ 1,285,439</b>	<b>\$ 1,276,959</b>

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

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

Consolidated Statements of Income (In Thousands Except Per Share Data) (Unaudited)	3 Months Ended		9 Months Ended	
	Sept. 30, 2018	Sept. 30, 2017	Sept. 30, 2018	Sept. 30, 2017
<b>INTEREST INCOME</b>				
Interest and fees on loans:				
Taxable	\$9,754	\$8,889	\$28,530	\$25,872
Tax-exempt	561	531	1,677	1,482
Interest on mortgages held for sale	3	10	9	20
Interest on balances with depository institutions	173	67	319	140
Income from available-for-sale debt securities:				
Taxable	1,624	1,335	4,368	4,090
Tax-exempt	680	789	2,105	2,459
Dividends on marketable equity security	5	5	16	15
Total interest and dividend income	12,800	11,626	37,024	34,078
<b>INTEREST EXPENSE</b>				
Interest on deposits	1,033	639	2,641	1,735
Interest on short-term borrowings	39	9	320	131
Interest on long-term borrowings	169	337	352	1,050
Total interest expense	1,241	985	3,313	2,916
Net interest income	11,559	10,641	33,711	31,162
Provision for loan losses	60	322	332	778
Net interest income after provision for loan losses	11,499	10,319	33,379	30,384
<b>NONINTEREST INCOME</b>				
Trust and financial management revenue	1,427	1,292	4,375	3,969
Brokerage revenue	235	187	718	551
Insurance commissions, fees and premiums	15	26	72	98
Service charges on deposit accounts	1,331	1,186	3,837	3,399
Service charges and fees	95	97	263	263
Interchange revenue from debit card transactions	660	561	1,880	1,649
Net gains from sale of loans	164	297	514	651
Loan servicing fees, net	74	35	263	162
Increase in cash surrender value of life insurance	100	97	295	281
Other noninterest income	361	288	1,340	1,013
Sub-total	4,462	4,066	13,557	12,036
Gain on restricted equity security	571	0	2,321	0
Realized (losses) gains on available-for-sale debt securities, net	(2 )	5	(284 )	257
Total noninterest income	5,031	4,071	15,594	12,293
<b>NONINTEREST EXPENSE</b>				
Salaries and wages	4,263	3,985	12,580	11,825
Pensions and other employee benefits	1,237	1,209	4,047	3,870
Occupancy expense, net	648	580	1,898	1,758
Furniture and equipment expense	317	340	901	968



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Data processing expenses	667	595	2,002	1,785
Automated teller machine and interchange expense	347	346	988	945
Pennsylvania shares tax	326	336	998	1,008
Professional fees	305	224	860	599
Telecommunications	177	143	567	409
Directors' fees	197	177	549	548
Other noninterest expense	1,349	1,257	4,022	3,851
Total noninterest expense	9,833	9,192	29,412	27,566
Income before income tax provision	6,697	5,198	19,561	15,111
Income tax provision	1,111	1,262	3,229	3,620
NET INCOME	\$5,586	\$3,936	\$16,332	\$11,491
EARNINGS PER COMMON SHARE - BASIC	\$0.45	\$0.32	\$1.33	\$0.94
EARNINGS PER COMMON SHARE - DILUTED	\$0.45	\$0.32	\$1.33	\$0.94

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

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

Consolidated Statements of Comprehensive Income (In Thousands) (Unaudited)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net income	\$ 5,586	\$ 3,936	\$ 16,332	\$ 11,491
Unrealized (losses) gains on available-for-sale securities:				
Unrealized holding (losses) gains on available-for-sale securities	(2,567 )	(213 )	(8,698 )	2,067
Reclassification adjustment for losses (gains) realized in income	2	(5 )	284	(257 )
Other comprehensive (loss) gain on available-for-sale securities	(2,565 )	(218 )	(8,414 )	1,810
Unfunded pension and postretirement obligations:				
Changes from plan amendments and actuarial gains and losses included in accumulated other comprehensive gain	0	0	93	166
Amortization of prior service cost and net actuarial loss included in net periodic benefit cost	(3 )	(6 )	(13 )	(18 )
Other comprehensive (loss) gain on unfunded retirement obligations	(3 )	(6 )	80	148
Other comprehensive (loss) income before income tax	(2,568 )	(224 )	(8,334 )	1,958
Income tax related to other comprehensive loss (income)	539	78	1,750	(686 )
Net other comprehensive (loss) income	(2,029 )	(146 )	(6,584 )	1,272
Comprehensive income	\$ 3,557	\$ 3,790	\$ 9,748	\$ 12,763

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In Thousands) (Unaudited)

9 Months Ended

Sept. 30, Sept. 30,  
2018 2017**CASH FLOWS FROM OPERATING ACTIVITIES:**

Net income	\$ 16,332	\$ 11,491
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	332	778
Realized losses (gains) on available-for-sale securities, net	284	(257 )
Unrealized loss on marketable equity security	30	0
Gain on restricted equity security	(2,321 )	0
Depreciation and amortization expense	1,317	1,239
Accretion and amortization on securities, net	747	866
Increase in cash surrender value of life insurance	(295 )	(281 )
Stock-based compensation and other expense	500	475
Deferred income taxes	(83 )	112
Decrease in fair value of servicing rights	58	145
Gains on sales of loans, net	(514 )	(651 )
Origination of loans for sale	(16,029)	(19,277)
Proceeds from sales of loans	16,617	19,473
Decrease in accrued interest receivable and other assets	138	207
Increase in accrued interest payable and other liabilities	1,067	624
Other	277	86
Net Cash Provided by Operating Activities	18,457	15,030

**CASH FLOWS FROM INVESTING ACTIVITIES:**

Proceeds from maturities of certificates of deposit	2,280	348
Purchase of certificates of deposit	(1,350 )	(100 )
Proceeds from sales of available-for-sale securities	17,755	24,118
Proceeds from calls and maturities of available-for-sale securities	36,648	47,285
Purchase of available-for-sale securities	(66,617)	(40,211)
Redemption of Federal Home Loan Bank of Pittsburgh stock	4,283	5,487
Purchase of Federal Home Loan Bank of Pittsburgh stock	(2,874 )	(4,725 )
Net increase in loans	(9,674 )	(50,128)
Proceeds from sale of restricted equity security	884	0
Proceeds from bank owned life insurance	1,443	0
Purchase of premises and equipment	(962 )	(1,209 )
Proceeds from sale of foreclosed assets	1,381	1,035
Other	128	144
Net Cash Used in Investing Activities	(16,675)	(17,956)

**CASH FLOWS FROM FINANCING ACTIVITIES:**

Net increase in deposits	35,498	37,782
Net decrease in short-term borrowings	(53,345)	(18,436)
Proceeds from long-term borrowings	24,000	3,000
Repayments of long-term borrowings	(204 )	(10,198)

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Sale of treasury stock	93	98
Common dividends paid	(8,797 )	(8,331 )
Net Cash (Used in) Provided by Financing Activities	(2,755 )	3,915
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(973 )	989
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	37,004	28,621
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$36,031	\$29,610

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Accrued sale of restricted equity security	\$1,437	\$0
Assets acquired through foreclosure of real estate loans	\$2,489	\$608
Interest paid	\$3,245	\$2,942
Income taxes paid	\$2,777	\$3,163

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

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

## Consolidated Statements of Changes in Stockholders' Equity

(In Thousands Except Share and Per Share Data)

(Unaudited)

	Common Shares	Treasury Shares	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total
Nine Months Ended September 30, 2018								
Balance, December 31, 2017	12,655,171	440,646	\$12,655	\$72,035	\$113,608	\$(1,507)	\$(8,348)	\$188,801
Impact of change in enacted income tax rate (a)					325	(325)		0
Impact of change in method of premium amortization of callable debt securities (b)					(26)	26		0
Impact of change in method of accounting for marketable equity security (c)					(22)	22		0
Net income					16,332			16,332
Other comprehensive loss, net						(6,584)		(6,584)
Cash dividends declared on common stock, \$0.81 per share					(9,934)			(9,934)
Shares issued for dividend reinvestment plan		(45,283)		279			858	1,100
Shares issued from treasury and redeemed related to exercise of stock options		(10,853)		(110)			203	930
Restricted stock granted		(34,552)		(655)			655	0
Forfeiture of restricted stock		7,939		148			(148)	0
Stock-based compensation expense				500				500
Balance, September 30, 2018	12,655,171	357,897	\$12,655	\$72,197	\$120,283	\$(8,368)	\$(6,780)	\$189,205
Nine Months Ended September 30, 2017								
Balance, December 31, 2016	12,655,171	541,943	\$12,655	\$71,730	\$112,790	\$(898)	\$(10,269)	\$186,711
Net income					11,491			11,491
Other comprehensive income, net						1,272		1,272
Cash dividends declared on common stock, \$0.78 per share					(9,445)			(9,445)

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Shares issued for dividend reinvestment plan	(48,092 )	203					911	1,1
Shares issued from treasury and redeemed related to exercise of stock options	(9,681 )	(86 )					184	98
Restricted stock granted	(30,782 )	(583 )					583	0
Forfeiture of restricted stock	4,256	79					(79 )	0
Stock-based compensation expense		475						475
Balance, September 30, 2017	12,655,171	457,644	\$12,655	\$71,818	\$114,836	\$374	\$(8,670 )	\$191

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

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

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

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

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

### **Notes to Unaudited Consolidated Financial Statements**

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

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

The consolidated financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2017, is unaudited. Such information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations, comprehensive income, cash flows and changes in stockholders’ equity for the interim periods; however, the information does not include all disclosures required by accounting principles generally accepted in the United States of America (“U.S. GAAP”) for a complete set of financial statements. Certain 2017 information has been reclassified for consistency with the 2018 presentation.

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

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

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

**Recent Accounting Pronouncements - Adopted**

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

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

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



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

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

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

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

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

As described in more detail in Note 6, in the second quarter 2018, an unrealized gain of \$866,000 (pre-tax) was recognized in the unaudited, consolidated statements of income on a restricted equity security (Visa Class B stock). As required by ASU 2016-01, the Corporation considered the pricing of observable transactions in determining the carrying value of this equity security that does not have a readily determinable fair value. In the third quarter 2018, the Corporation sold the shares held as of June 30, 2018, recording an additional gain of \$571,000 as the proceeds of \$1,437,000 exceeded the carrying value of the restricted equity security of \$866,000 prior to the sale.

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

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

ASU 2016-02, Leases (Topic 842) changes current GAAP by requiring that lease assets and liabilities arising from operating leases be recognized on the balance sheet. In July 2018, the FASB issued ASU 2018-10 and ASU 2018-11, Codification Improvements to Topic 842, Leases, amending various aspects of Topic 842. Topic 842 would not significantly change the recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee from current U.S. GAAP. For leases with a term of 12 months or less, a lessee would be permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and liabilities. Topic 842 will become effective for the Corporation for annual and interim periods beginning in the first quarter 2019. Adoption of

Topic 842 is not expected to have a material impact on the Corporation's consolidated financial statements. The Corporation leases certain properties and equipment under operating leases that will result in the recognition of lease assets and lease liabilities on the consolidated balance sheet under Topic 842; however, the majority of the Corporation's properties and equipment are owned, not leased.

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

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

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

ASU 2018-13, Fair Value Measurement (Topic 820) modifies disclosure requirements on fair value measurements. This ASU removes requirements to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, the policy for timing of transfers between levels and the valuation processes for Level 3 fair value measurements. ASU 2018-13 clarifies that disclosure regarding measurement uncertainty is intended to communicate information about the uncertainty in measurement as of the reporting date. ASU 2018-13 adds certain disclosure requirements, including disclosure of changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. The amendments in this ASU are effective for the Corporation beginning in the first quarter 2020. The amendments on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty should be applied prospectively, while all other amendments should be applied retrospectively for all periods presented. The Corporation does not expect adoption of this ASU to have a material impact on its consolidated financial position or results of operations.

ASU 2018-14, Compensation - Retirement Benefits - Defined Benefit Plans – General (Subtopic 715-20) modifies the disclosure requirements for defined benefit and other postretirement plans. This ASU eliminates certain disclosures associated with accumulated other comprehensive income, plan assets, related parties, and the effects of interest rate basis point changes on assumed health care costs; while other disclosures have been added to address significant gains and losses related to changes in benefit obligations. This ASU also clarifies disclosure requirements for projected benefit and accumulated benefit obligations. The amendments in this ASU are effective for the Corporation beginning in the first quarter 2021. Adoption on a retrospective basis for all periods presented is required. The Corporation does not expect adoption of this ASU to have a material impact on its consolidated financial statements.

ASU 2018-15, Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40) was issued to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (hosting arrangement) by providing guidance for determining when the arrangement includes a software license. The amendments align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by the amendments. This guidance will become effective for the Corporation beginning in the first quarter 2020, with early adoption permitted. The Corporation does not expect adoption of this ASU to have a material impact on its consolidated financial statements.

## **2. PER SHARE DATA**

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

Diluted earnings per common share are calculated under the more dilutive of either the treasury method or the two-class method. Diluted earnings per common share is computed using weighted-average common shares outstanding, plus weighted-average common shares available from the exercise of all dilutive stock options, less the number of shares that could be repurchased with the proceeds of stock option exercises based on the average share price of the Corporation's common stock during the period.

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	3 Months Ended		9 Months Ended	
	Sept. 30, 2018	Sept. 30, 2017	Sept. 30, 2018	Sept. 30, 2017
Basic				
Net income	\$5,586,000	\$3,936,000	\$16,332,000	\$11,491,000
Less: Dividends and undistributed earnings allocated to participating securities	(28,000 )	(20,000 )	(83,000 )	(59,000 )
Net income attributable to common shares	\$5,558,000	\$3,916,000	\$16,249,000	\$11,432,000
Basic weighted-average common shares outstanding	12,228,833	12,124,854	12,209,879	12,105,673
Basic earnings per common share (a)	\$0.45	\$0.32	\$1.33	\$0.94
Diluted				
Net income attributable to common shares	\$5,558,000	\$3,916,000	\$16,249,000	\$11,432,000
Basic weighted-average common shares outstanding	12,228,833	12,124,854	12,209,879	12,105,673
Dilutive effect of potential common stock arising from stock options	42,703	37,409	38,790	40,624
Diluted weighted-average common shares outstanding	12,271,536	12,162,263	12,248,669	12,146,297
Diluted earnings per common share (a)	\$0.45	\$0.32	\$1.33	\$0.94
Weighted-average non-vested restricted shares outstanding	60,462	61,233	62,262	62,825

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

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

**3. COMPREHENSIVE INCOME**

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

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(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Nine Months Ended September 30, 2018			
Unrealized losses on available-for-sale securities:			
Unrealized holding losses on available-for-sale securities	\$ (8,698 )	\$ 1,826	\$ (6,872 )
Reclassification adjustment for losses realized in income	284	(59 )	225
Other comprehensive loss on available-for-sale securities	(8,414 )	1,767	(6,647 )
Unfunded pension and postretirement obligations:			
Changes from plan amendments and actuarial gains and losses included in other comprehensive income	93	(19 )	74
Amortization of prior service cost and net actuarial loss included in net periodic benefit cost	(13 )	2	(11 )
Other comprehensive income on unfunded retirement obligations	80	(17 )	63
Total other comprehensive loss	\$ (8,334 )	\$ 1,750	\$ (6,584 )

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(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Nine Months Ended September 30, 2017			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	\$ 2,067	\$ (723 )	\$ 1,344
Reclassification adjustment for (gains) realized in income	(257 )	89	(168 )
Other comprehensive income on available-for-sale securities	1,810	(634 )	1,176
Unfunded pension and postretirement obligations:			
Changes from plan amendments and actuarial gains and losses included in other comprehensive income	166	(58 )	108
Amortization of prior service cost and net actuarial loss included in net periodic benefit cost	(18 )	6	(12 )
Other comprehensive income on unfunded retirement obligations	148	(52 )	96
Total other comprehensive income	\$ 1,958	\$ (686 )	\$ 1,272

(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Three Months Ended September 30, 2018			
Unrealized losses on available-for-sale securities:			
Unrealized holding losses on available-for-sale securities	\$ (2,567 )	\$ 539	\$ (2,028 )
Reclassification adjustment for losses realized in income	2	(0 )	2
Other comprehensive loss on available-for-sale securities	(2,565 )	539	(2,026 )
Unfunded pension and postretirement obligations:			
Changes from plan amendments and actuarial gains and losses included in other comprehensive income	0	0	0
Amortization of prior service cost and net actuarial loss included in net periodic benefit cost	(3 )	0	(3 )
Other comprehensive loss on unfunded retirement obligations	(3 )	0	(3 )
Total other comprehensive loss	\$ (2,568 )	\$ 539	\$ (2,029 )

(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
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Three Months Ended September 30, 2017

Unrealized losses on available-for-sale securities:

Unrealized holding losses on available-for-sale securities	\$ (213 )	\$ 75	\$ (138 )
Reclassification adjustment for (gains) realized in income	(5 )	1	(4 )
Other comprehensive loss on available-for-sale securities	(218 )	76	(142 )

Unfunded pension and postretirement obligations:

Changes from plan amendments and actuarial gains and losses included in other comprehensive income	0	0	0
Amortization of prior service cost and net actuarial loss included in net periodic benefit cost	(6 )	2	(4 )
Other comprehensive loss on unfunded retirement obligations	(6 )	2	(4 )

Total other comprehensive loss	\$ (224 )	\$ 78	\$ (146 )
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Changes in the components of accumulated other comprehensive income (loss) are as follows and are presented net of tax:

(In Thousands)	Unrealized (Losses) Gains on Securities	Unfunded Retirement Obligations	Accumulated Other Comprehensive Loss
<b>Nine Months Ended September 30, 2018</b>			
Balance, beginning of period	\$ (1,566 )	\$ 59	\$ (1,507 )
Impact of change in enacted income tax rate	(337 )	12	(325 )
Impact of change in the method of premium amortization of callable debt securities	26	0	26
Impact of change in the method of accounting for marketable equity security	22	0	22
Other comprehensive (loss) income during nine months ended September 30, 2018	(6,647 )	63	(6,584 )
Balance, end of period	\$ (8,502 )	\$ 134	\$ (8,368 )
<b>Nine Months Ended September 30, 2017</b>			
Balance, beginning of period	\$ (949 )	\$ 51	\$ (898 )
Other comprehensive income during nine months ended September 30, 2017	1,176	96	1,272
Balance, end of period	\$ 227	\$ 147	\$ 374
<b>Three Months Ended September 30, 2018</b>			
Balance, beginning of period	\$ (6,476 )	\$ 137	\$ (6,339 )
Other comprehensive (loss) during three months ended September 30, 2018	(2,026 )	(3 )	(2,029 )
Balance, end of period	\$ (8,502 )	\$ 134	\$ (8,368 )
<b>Three Months Ended September 30, 2017</b>			
Balance, beginning of period	\$ 369	\$ 151	\$ 520
Other comprehensive (loss) during three months ended September 30, 2017	(142 )	(4 )	(146 )
Balance, end of period	\$ 227	\$ 147	\$ 374

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

For the Nine Months Ended September 30, 2018

(In Thousands)

Details about Accumulated Other	Reclassified from Accumulated Other Comprehensive Loss	Affected Line Item in the Consolidated Statements of Income
Comprehensive Loss Components		
Unrealized gains and losses on available-for-sale securities	\$ 284 (59) 225	Realized losses on available-for-sale debt securities, net ) Income tax provision Net of tax
Amortization of defined benefit pension and postretirement items:		
Prior service cost	(23	) Other noninterest expense
Actuarial loss	10	Other noninterest expense
	(13	) Total before tax
	2	Income tax provision
	(11	) Net of tax
Total reclassifications for the period	\$ 214	

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For the Nine Months Ended September 30, 2017  
(In Thousands)

Details about Accumulated Other Comprehensive Loss Components	Reclassified from Accumulated Other Comprehensive Loss	Affected Line Item in the Consolidated Statements of Income
Unrealized gains and losses on available-for-sale securities	\$ (257 )	Realized gains on available-for-sale debt securities, net
	89	Income tax provision
	(168 )	Net of tax
Amortization of defined benefit pension and postretirement items:		
Prior service cost	(23 )	Other noninterest expense
Actuarial loss	5	Other noninterest expense
	(18 )	Total before tax
	6	Income tax provision
	(12 )	Net of tax
Total reclassifications for the period	\$ (180 )	

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

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

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

Details about Accumulated Other Comprehensive Loss Components	Reclassified from Accumulated Other Comprehensive Loss	Affected Line Item in the Consolidated Statements of Income
Unrealized gains and losses on available-for-sale securities	\$ (5 )	Realized gains on available-for-sale debt securities, net
	1	Income tax provision
	(4 )	Net of tax
Amortization of defined benefit pension and postretirement items:		
Prior service cost	(8 )	Other noninterest expense
Actuarial loss	2	Other noninterest expense
	(6 )	Total before tax
	2	Income tax provision
	(4 )	Net of tax
Total reclassifications for the period	\$ (8 )	

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### 4. CASH AND DUE FROM BANKS

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

(In thousands)	Sept. 30, 2018	Dec. 31, 2017
Cash and cash equivalents	\$36,031	\$37,004
Certificates of deposit	2,310	3,240
Total cash and due from banks	\$38,341	\$40,244

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

The Corporation is required to maintain reserves against deposit liabilities in the form of cash and balances with the Federal Reserve Bank of Philadelphia. The reserves are based on deposit levels, account activity, and other services provided by the Federal Reserve Bank. Required reserves were \$14,783,000 at September 30, 2018 and \$17,178,000 at December 31, 2017.

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

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

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

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

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

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.

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

	Quoted Prices in Active Markets (Level 1)	September 30, 2018		
		Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total Fair Value
(In Thousands)				
Recurring fair value measurements				
AVAILABLE-FOR-SALE DEBT SECURITIES:				
Obligations of U.S. Government agencies	\$ 0	\$4,768	\$ 0	\$4,768
Obligations of states and political subdivisions:				
Tax-exempt	0	91,712	0	91,712
Taxable	0	27,642	0	27,642
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:				
Residential pass-through securities	0	55,131	0	55,131
Residential collateralized mortgage obligations	0	142,631	0	142,631
Commercial mortgage-backed securities	0	36,822	0	36,822
Total available-for-sale debt securities	0	358,706	0	358,706
Marketable equity security	941	0	0	941
Servicing rights	0	0	1,381	1,381
Total recurring fair value measurements	\$ 941	\$358,706	\$ 1,381	\$361,028
Nonrecurring fair value measurements				
Impaired loans with a valuation allowance	\$ 0	\$0	\$ 3,623	\$3,623
Valuation allowance	0	0	(1,059 )	(1,059 )
Impaired loans, net	0	0	2,564	2,564
Foreclosed assets held for sale	0	0	2,678	2,678
Total nonrecurring fair value measurements	\$ 0	\$0	\$ 5,242	\$5,242

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

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

At September 30, 2018 and December 31, 2017, quantitative information regarding significant techniques and inputs used for assets measured on a recurring basis using unobservable inputs (Level 3 methodologies) are as follows:

Fair Value at



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Asset	9/30/18 (In Thousands)	Valuation Technique	Unobservable Input(s)	Method or Value As of 9/30/18
Servicing rights	\$ 1,381	Discounted cash flow	Discount rate	12.50 % Rate used through modeling period
			Loan prepayment speeds	121.00 % 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
				\$ 6.00 Monthly servicing cost per account
				\$ 24.00 Additional monthly servicing cost per loan on loans more than 30 days delinquent
				1.50 % of loans more than 30 days delinquent
				3.00 % annual increase in servicing costs

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Asset	Fair Value at 12/31/17 (In Thousands)	Valuation Technique	Unobservable Input(s)	Method or Value As of 12/31/17
Servicing rights	\$ 1,299	Discounted cash flow	Discount rate	13.00 % Rate used through modeling period
			Loan prepayment speeds	140.00 % Weighted-average PSA
			Servicing fees	0.25 % of loan balances
				4.00 % of payments are late
				5.00 % late fees assessed
				\$ 1.94 Miscellaneous fees per account per month
			Servicing costs	\$ 6.00 Monthly servicing cost per account
				\$ 24.00 Additional monthly servicing cost per loan on loans more than 30 days delinquent
				1.50 % of loans more than 30 days delinquent
				3.00 % annual increase in servicing costs

The fair value of servicing rights is affected by expected future interest rates. Increases (decreases) in future expected interest rates tend to increase (decrease) the fair value of the Corporation's servicing rights because of changes in expected prepayment behavior by the borrowers on the underlying loans. Unrealized gains (losses) in fair value of servicing rights are included in Loan servicing fees, net, in the unaudited consolidated statements of income.

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

(In Thousands)	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Restricted Equity Security	Servicing Rights	Total	Restricted Equity Security	Servicing Rights	Total
Balance, beginning of period	\$ 866	\$ 1,370	\$ 2,236	\$ 0	\$ 1,299	\$ 1,299
Issuances of servicing rights	0	43	43	0	140	140
Unrealized gains (losses) included in earnings	(866 )	(32 )	(898 )	0	(58 )	(58 )
Balance, end of period	\$ 0	\$ 1,381	\$ 1,381	\$ 0	\$ 1,381	\$ 1,381

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(In Thousands)	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Restricted Equity Security	Servicing Rights	Total	Restricted Equity Security	Servicing Rights	Total
Balance, beginning of period	\$ 0	\$ 1,279	\$ 1,279	\$ 0	\$ 1,262	\$ 1,262
Issuances of servicing rights	0	65	65	0	160	160
Unrealized gains (losses) included in earnings	0	(67 )	(67 )	0	(145 )	(145 )
Balance, end of period	\$ 0	\$ 1,277	\$ 1,277	\$ 0	\$ 1,277	\$ 1,277

Loans are classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Foreclosed assets held for sale consist of real estate acquired by foreclosure. For impaired commercial loans secured by real estate and foreclosed assets held for sale, estimated fair values are determined primarily using values from third-party appraisals. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property. For commercial and industrial and agricultural loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging data or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

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

(In Thousands, Except Percentages)						Weighted-Average Discount at	
Asset	Balance at 9/30/18	Valuation Allowance at 9/30/18	Fair Value at 9/30/18	Valuation Technique	Unobservable Inputs	at 9/30/18	
Impaired loans:							
Residential mortgage loans - first liens	\$ 509	\$ 118	\$ 391	Sales comparison	Discount to appraised value	26	%
Commercial:							
Commercial loans secured by real estate	2,550	816	1,734	Sales comparison	Discount to appraised value	16	%
Commercial and industrial	75	75	0	Sales comparison	Discount to appraised value	100	%
Loans secured by farmland	489	50	439	Sales comparison	Discount to appraised value	56	%
Total impaired loans	\$ 3,623	\$ 1,059	\$ 2,564				
Foreclosed assets held for sale - real estate:							
Residential (1-4 family)	\$ 328	\$ 0	\$ 328	Sales comparison	Discount to appraised value	46	%
Land	110	0	110	Sales comparison	Discount to appraised value	61	%
Commercial real estate	2,240	0	2,240	Sales comparison	Discount to appraised value	32	%
Total foreclosed assets held for sale	\$ 2,678	\$ 0	\$ 2,678				

(In Thousands, Except Percentages)						Weighted-Average Discount at	
Asset	Balance at 12/31/17	Valuation Allowance at 12/31/17	Fair Value at 12/31/17	Valuation Technique	Unobservable Inputs	at 12/31/17	
Impaired loans:							
Residential mortgage loans - first liens	\$ 515	\$ 122	\$ 393	Sales comparison	Discount to appraised value	26	%
Commercial:							
Commercial loans secured by real estate	2,641	919	1,722	Sales comparison	Discount to appraised value	16	%
Commercial and industrial	126	92	34	Sales comparison	Discount to appraised value	72	%

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

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

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

(In Thousands)	Fair Value Hierarchy Level	September 30, 2018 Carrying Amount	Fair Value	December 31, 2017 Carrying Amount	Fair Value
<b>Financial assets:</b>					
Cash and cash equivalents	Level 1	\$36,031	\$36,031	\$37,004	\$37,004
Certificates of deposit	Level 2	2,310	2,298	3,240	3,234
Restricted equity securities (included in Other Assets)	Level 2	5,147	5,147	6,556	6,556
Loans, net	Level 3	813,717	811,384	806,857	789,891
Accrued interest receivable	Level 2	4,279	4,279	4,048	4,048
<b>Financial liabilities:</b>					
Deposits with no stated maturity	Level 2	815,607	815,607	794,778	794,778
Time deposits	Level 2	228,340	228,484	213,671	213,734
Short-term borrowings	Level 2	8,421	8,185	61,766	61,643
Long-term borrowings	Level 2	32,985	32,987	9,189	9,256
Accrued interest payable	Level 2	114	114	46	46

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

**6. SECURITIES**

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

	September 30, 2018		
	Gross	Gross	
	Unrealized	Unrealized	
Amortized	Holding	Holding	Fair

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(In Thousands)	Cost	Gains	Losses	Value
Obligations of U.S. Government agencies	\$ 4,815	\$ 0	\$ (47	) \$ 4,768
Obligations of states and political subdivisions:				
Tax-exempt	92,837	1,104	(2,229	) 91,712
Taxable	27,975	21	(354	) 27,642
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:				
Residential pass-through securities	57,279	46	(2,194	) 55,131
Residential collateralized mortgage obligations	148,074	8	(5,451	) 142,631
Commercial mortgage-backed securities	38,488	0	(1,666	) 36,822
Total available-for-sale-debt securities	\$ 369,468	\$ 1,179	\$ (11,941	) \$ 358,706

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

(In Thousands)	December 31, 2017			
	Amortized Cost	Gross Holding Gains	Gross Holding Losses	Fair Value
Obligations of U.S. Government agencies	\$8,026	\$0	\$ (153 )	\$7,873
Obligations of states and political subdivisions:				
Tax-exempt	103,673	2,291	(853 )	105,111
Taxable	25,431	226	(84 )	25,573
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:				
Residential pass-through securities	52,992	79	(724 )	52,347
Residential collateralized mortgage obligations	134,314	110	(2,610 )	131,814
Commercial mortgage-backed securities	33,881	4	(666 )	33,219
Total available-for-sale debt securities	\$358,317	\$2,710	\$ (5,090 )	\$355,937

The following table presents gross unrealized losses and fair value of available-for-sale debt 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, 2018 and December 31, 2017:

September 30, 2018 (In Thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of U.S. Government agencies	\$4,768	\$ (47 )	\$0	\$0	\$4,768	\$ (47 )
Obligations of states and political subdivisions:						
Tax-exempt	25,713	(465 )	28,785	(1,764 )	54,498	(2,229 )
Taxable	16,635	(200 )	5,362	(154 )	21,997	(354 )
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:						
Residential pass-through securities	13,528	(178 )	40,904	(2,016 )	54,432	(2,194 )
Residential collateralized mortgage obligations	53,399	(884 )	87,703	(4,567 )	141,102	(5,451 )
Commercial mortgage-backed securities	8,798	(147 )	28,024	(1,519 )	36,822	(1,666 )
Total temporarily impaired available-for-sale debt securities	\$122,841	\$ (1,921 )	\$190,778	\$ (10,020 )	\$313,619	\$ (11,941 )

December 31, 2017	Less Than 12 Months	12 Months or More	Total
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(In Thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of U.S. Government agencies	\$0	\$0	\$7,873	\$(153)	\$7,873	\$(153)
Obligations of states and political subdivisions:						
Tax-exempt	19,050	(135)	24,391	(718)	43,441	(853)
Taxable	9,279	(45)	2,116	(39)	11,395	(84)
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:						
Residential pass-through securities	25,255	(242)	22,549	(482)	47,804	(724)
Residential collateralized mortgage obligations	50,812	(589)	68,558	(2,021)	119,370	(2,610)
Commercial mortgage-backed securities	14,713	(173)	14,569	(493)	29,282	(666)
Total temporarily impaired available-for-sale debt securities	\$119,109	\$(1,184)	\$140,056	\$(3,906)	\$259,165	\$(5,090)

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

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

(In Thousands)	3 Months Ended		9 Months Ended	
	Sept. 30, 2018	Sept. 30, 2017	Sept. 30, 2018	Sept. 30, 2017
Gross realized gains from sales and calls	\$ 45	\$ 47	\$ 45	\$ 315
Gross realized losses from sales	(47 )	(42 )	(329 )	(58 )
Net realized (losses) gains	\$ (2 )	\$ 5	\$ (284 )	\$ 257

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, 2018. Actual maturities may differ from contractual maturities because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

(In Thousands)	Amortized Fair	
	Cost	Value
Due in one year or less	\$23,128	\$23,337
Due from one year through five years	39,807	39,533
Due from five years through ten years	38,688	37,515
Due after ten years	24,004	23,737
Sub-total	125,627	124,122
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:		
Residential pass-through securities	57,279	55,131
Residential collateralized mortgage obligations	148,074	142,631
Commercial mortgage-backed securities	38,488	36,822
Total	\$369,468	\$358,706

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

Investment securities carried at \$236,671,000 at September 30, 2018 and \$217,925,000 at December 31, 2017 were pledged as collateral for public deposits, trusts and certain other deposits as provided by law. See Note 8 for information concerning securities pledged to secure borrowing arrangements.

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

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

#### **Debt Securities**

At September 30, 2018, management performed an assessment for possible OTTI of the Corporation's debt securities on an issue-by-issue basis, relying on information obtained from various sources, including publicly available financial data, ratings by external agencies, brokers and other sources. The extent of individual analysis applied to each security depended on the size of the Corporation's investment, as well as management's perception of the credit risk associated with each security. Based on the results of the assessment, management believes impairment of debt securities at September 30, 2018 and December 31, 2017 to be temporary.

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

### **Equity Securities**

The Corporation's marketable equity security, with a carrying value of \$941,000 at September 30, 2018 and \$971,000 at December 31, 2017, consisted exclusively of one mutual fund. There was an unrealized loss on the mutual fund of \$59,000 at September 30, 2018 and \$29,000 at December 31, 2017. The increase in the unrealized loss of \$7,000 in the third quarter of 2018 and \$30,000 in the nine months ended September 30, 2018 is included in other noninterest income in the consolidated statements of income.

C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 11 regional Federal Home Loan Banks. As a member, C&N Bank is required to purchase and maintain stock in FHLB-Pittsburgh. There is no active market for FHLB-Pittsburgh stock, and it must ordinarily be redeemed by FHLB-Pittsburgh in order to be liquidated. C&N Bank's investment in FHLB-Pittsburgh stock, included in Other Assets in the consolidated balance sheet, was \$5,017,000 at September 30, 2018 and \$6,426,000 at December 31, 2017. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at September 30, 2018 and December 31, 2017. In making this determination, management concluded that recovery of total outstanding par value, which equals the carrying value, is expected. The decision was based on review of financial information that FHLB-Pittsburgh has made publicly available.

In the second quarter 2018, the Corporation recorded a pre-tax gain on a restricted equity security (Visa Class B stock) of \$1,750,000. The Corporation had received 19,789 shares of Visa Class B stock pursuant to Visa's 2007 initial public offering. Until the second quarter 2018, the carrying value of the shares was \$0, which represented the Corporation's cost basis. Class B shares are subject to restrictions on transfer, essentially limiting their transferability to other owners of Class B shares. In June 2018, the Corporation sold 10,000 of the shares for a price of \$88.43 per share in a transaction that settled in July 2018. As required by "U.S. GAAP", companies must consider the pricing of observable transactions in determining the carrying value of equity securities that do not have readily determinable fair values. Accordingly, the Corporation's second quarter 2018 gain was based on the price per share of the sale initiated in June 2018, applied to the total of 19,789 shares. In the third quarter 2018, the Corporation sold the remaining 9,789 shares for \$1,437,000, or approximately \$146.80 per share, recognizing an additional gain of \$571,000. At September 30, 2018, the balance of other assets in the unaudited, consolidated balance sheet included a receivable of \$1,437,000 from the third quarter 2018 sale of the Visa Class B shares.

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

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(In Thousands)	3 Months Ended		9 Months Ended	
	Sept. 30,	Sept. 30,	Sept. 30,	Sept. 30,
	2018	2017	2018	2017
Net gains and losses recognized during the period on equity securities	\$ 564	\$ 0	\$ 2,291	\$ 0
Less: net gains and losses recognized during the period on equity securities sold during the period	(571 )	0	(2,321 )	0
Unrealized gains and losses recognized during the period on equity securities still held at the reporting date	\$ (7 )	\$ 0	\$ (30 )	\$ 0

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

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

Summary of Loans by Type (In Thousands)	Sept. 30, 2018	Dec. 31, 2017
Residential mortgage:		
Residential mortgage loans - first liens	\$366,516	\$359,987
Residential mortgage loans - junior liens	25,748	25,325
Home equity lines of credit	34,283	35,758
1-4 Family residential construction	27,661	26,216
Total residential mortgage	454,208	447,286
Commercial:		
Commercial loans secured by real estate	159,212	159,266
Commercial and industrial	91,472	88,276
Political subdivisions	53,294	59,287
Commercial construction and land	12,278	14,527
Loans secured by farmland	7,208	7,255
Multi-family (5 or more) residential	7,670	7,713
Agricultural loans	5,670	6,178
Other commercial loans	14,140	10,986
Total commercial	350,944	353,488
Consumer	17,380	14,939
Total	822,532	815,713
Less: allowance for loan losses	(8,815 )	(8,856 )
Loans, net	\$813,717	\$806,857

The Corporation grants loans to individuals as well as commercial and tax-exempt entities. Commercial, residential and personal loans are made to customers geographically concentrated in the Pennsylvania and New York counties that comprise the market serviced by Citizens & Northern Bank. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. There is no concentration of loans to borrowers engaged in similar businesses or activities that exceed 10% of total loans at either September 30, 2018 or December 31, 2017.

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. In the process of evaluating the loan portfolio, management also considers the Corporation's exposure to losses from unfunded loan commitments. As of September 30, 2018 and December 31, 2017, management determined that no allowance for credit losses related to unfunded loan commitments was required.

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

Three Months Ended September 30, 2018 (In Thousands)	June 30, 2018 Balance	Charge-offs	Recoveries	Provision (Credit)	Sept. 30, 2018 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	\$ 3,055	\$ (21 )	\$ 1	\$ 98	\$ 3,133
Residential mortgage loans - junior liens	353	0	1	(25 )	329
Home equity lines of credit	292	(13 )	0	15	294
1-4 Family residential construction	247	0	0	(21 )	226
Total residential mortgage	3,947	(34 )	2	67	3,982
Commercial:					
Commercial loans secured by real estate	2,613	0	0	(67 )	2,546
Commercial and industrial	973	(11 )	2	34	998
Commercial construction and land	135	0	0	(21 )	114
Loans secured by farmland	106	0	0	(2 )	104
Multi-family (5 or more) residential	174	0	0	(7 )	167
Agricultural loans	46	0	0	0	46
Other commercial loans	134	0	0	(3 )	131
Total commercial	4,181	(11 )	2	(66 )	4,106
Consumer	204	(47 )	12	59	228
Unallocated	499	0	0	0	499
Total Allowance for Loan Losses	\$ 8,831	\$ (92 )	\$ 16	\$ 60	\$ 8,815

Three Months Ended September 30, 2017 (In Thousands)	June 30, 2017 Balance	Charge-offs	Recoveries	Provision (Credit)	Sept. 30, 2017 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	\$ 3,052	\$ 0	\$ 1	\$ 112	\$ 3,165
Residential mortgage loans - junior liens	261	0	1	3	265
Home equity lines of credit	332	0	0	(6 )	326
1-4 Family residential construction	251	0	0	(8 )	243
Total residential mortgage	3,896	0	2	101	3,999
Commercial:					
Commercial loans secured by real estate	2,610	0	0	27	2,637
Commercial and industrial	910	0	1	93	1,004
Commercial construction and land	162	0	0	(13 )	149



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Loans secured by farmland	107	0	0	3	110
Multi-family (5 or more) residential	169	0	0	2	171
Agricultural loans	42	0	0	16	58
Other commercial loans	105	0	0	12	117
Total commercial	4,105	0	1	140	4,246
Consumer	134	(67 )	7	81	155
Unallocated	500	0	0	0	500
Total Allowance for Loan Losses	\$ 8,635	\$ (67 )	\$ 10	\$ 322	\$ 8,900

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Nine Months Ended September 30, 2018 (In Thousands)	Dec. 31, 2017 Balance	Charge-offs	Recoveries	Provision (Credit)	Sept. 30, 2018 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	\$ 3,200	\$ (108 )	\$ 3	\$ 38	\$ 3,133
Residential mortgage loans - junior liens	224	0	4	101	329
Home equity lines of credit	296	(25 )	0	23	294
1-4 Family residential construction	243	0	0	(17 )	226
Total residential mortgage	3,963	(133 )	7	145	3,982
Commercial:					
Commercial loans secured by real estate	2,584	(21 )	0	(17 )	2,546
Commercial and industrial	1,065	(144 )	5	72	998
Commercial construction and land	150	0	0	(36 )	114
Loans secured by farmland	105	0	0	(1 )	104
Multi-family (5 or more) residential	172	0	0	(5 )	167
Agricultural loans	57	0	0	(11 )	46
Other commercial loans	102	0	0	29	131
Total commercial	4,235	(165 )	5	31	4,106
Consumer	159	(120 )	33	156	228
Unallocated	499	0	0	0	499
Total Allowance for Loan Losses	\$ 8,856	\$ (418 )	\$ 45	\$ 332	\$ 8,815

Nine Months Ended September 30, 2017 (In Thousands)	Dec. 31, 2016 Balance	Charge-offs	Recoveries	Provision (Credit)	Sept. 30, 2017 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	\$ 3,033	\$ (162 )	\$ 15	\$ 279	\$ 3,165
Residential mortgage loans - junior liens	258	(16 )	3	20	265
Home equity lines of credit	350	0	0	(24 )	326
1-4 Family residential construction	249	0	0	(6 )	243
Total residential mortgage	3,890	(178 )	18	269	3,999
Commercial:					
Commercial loans secured by real estate	2,380	(96 )	0	353	2,637
Commercial and industrial	999	(1 )	3	3	1,004
Commercial construction and land	162	0	0	(13 )	149
Loans secured by farmland	110	0	0	0	110
Multi-family (5 or more) residential	241	0	0	(70 )	171
Agricultural loans	40	0	0	18	58
Other commercial loans	115	0	0	2	117
Total commercial	4,047	(97 )	3	293	4,246

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Consumer	138	(127 )	30	114	155
Unallocated	398	0	0	102	500
Total Allowance for Loan Losses	\$ 8,473	\$ (402 )	\$ 51	\$ 778	\$ 8,900

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

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

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

September 30, 2018  
(In Thousands)

	Pass	Special Mention	Substandard	Doubtful	Total
<b>Residential Mortgage:</b>					
Residential mortgage loans - first liens	\$357,841	\$ 281	\$ 8,342	\$ 52	\$366,516
Residential mortgage loans - junior liens	25,214	95	439	0	25,748
Home equity lines of credit	33,611	59	613	0	34,283
1-4 Family residential construction	27,661	0	0	0	27,661
Total residential mortgage	444,327	435	9,394	52	454,208
<b>Commercial:</b>					
Commercial loans secured by real estate	152,701	765	5,746	0	159,212
Commercial and Industrial	85,405	4,922	1,145	0	91,472
Political subdivisions	53,294	0	0	0	53,294
Commercial construction and land	12,202	0	76	0	12,278
Loans secured by farmland	5,218	611	1,367	12	7,208
Multi-family (5 or more) residential	7,278	0	392	0	7,670
Agricultural loans	4,912	84	674	0	5,670
Other commercial loans	14,069	0	71	0	14,140
Total commercial	335,079	6,382	9,471	12	350,944
Consumer	17,336	0	44	0	17,380
<b>Totals</b>	<b>\$796,742</b>	<b>\$ 6,817</b>	<b>\$ 18,909</b>	<b>\$ 64</b>	<b>\$822,532</b>

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December 31, 2017

(In Thousands)

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

The general component of the allowance for loan losses covers pools of loans including commercial loans not considered individually impaired, as well as smaller balance homogeneous classes of loans, such as residential real estate, home equity lines of credit and other consumer loans. Accordingly, the Corporation generally does not separately identify individual consumer and residential loans for impairment disclosures, unless such a loan: (1) is subject to a restructuring agreement, or (2) has an outstanding balance of \$400,000 or more and a credit grade of Special Mention, Substandard or Doubtful. The pools of loans are evaluated for loss exposure based upon average historical net charge-off rates for each loan class, adjusted for qualitative factors (described in the following paragraphs). The time period used in determining the average historical net charge-off rate for each loan class is based on management's evaluation of an appropriate time period that captures an historical loss experience relevant to the current portfolio. At September 30, 2018 and December 31, 2017, a five-year average net charge-off rate was used for commercial loans secured by real estate and for multi-family residential loans, while a three-year average net charge-off rate was used for all other loan classes.

Qualitative risk factors are evaluated for the impact on each of the three segments (residential mortgage, commercial and consumer) within the loan portfolio. Each qualitative factor is assigned a value to reflect improving, stable or declining conditions based on management's judgment using relevant information available at the time of the evaluation. The adjustment for qualitative factors is applied as an increase or decrease to the average net charge-off rate for each loan class within each segment.

The qualitative factors used in the general component calculations are designed to address credit risk characteristics associated with each segment. The Corporation's credit risk associated with all of the segments is significantly impacted by these factors, which include economic conditions within its market area, the Corporation's lending policies, changes or trends in the portfolio, risk profile, competition, regulatory requirements and other factors. Further, the residential mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation's commercial segment loans (approximately 54% at September 30, 2018) is secured by real estate, and accordingly, the Corporation's risk for the commercial segment is significantly affected by commercial real estate values. The consumer segment includes a wide mix of loans for different purposes, primarily secured loans, including loans secured by motor vehicles, manufactured housing and other types of collateral.

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

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

The following tables present a summary of loan balances and the related allowance for loan losses summarized by portfolio segment and class for each impairment method used as of September 30, 2018 and December 31, 2017:

September 30, 2018 (In Thousands)	Loans:			Allowance for Loan Losses:		
	Individually Evaluated	Collectively Evaluated	Totals	Individually Evaluated	Collectively Evaluated	Totals
Residential mortgage:						
Residential mortgage loans - first liens	\$994	\$ 365,522	\$366,516	\$ 0	\$ 3,133	\$ 3,133
Residential mortgage loans - junior liens	293	25,455	25,748	118	211	329
Home equity lines of credit	0	34,283	34,283	0	294	294
1-4 Family residential construction	0	27,661	27,661	0	226	226
Total residential mortgage	1,287	452,921	454,208	118	3,864	3,982

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Commercial:

Commercial loans secured by real estate	4,155	155,057	159,212	816	1,730	2,546
Commercial and industrial	201	91,271	91,472	75	923	998
Political subdivisions	0	53,294	53,294	0	0	0
Commercial construction and land	0	12,278	12,278	0	114	114
Loans secured by farmland	1,352	5,856	7,208	50	54	104
Multi-family (5 or more) residential	392	7,278	7,670	0	167	167
Agricultural loans	674	4,996	5,670	0	46	46
Other commercial loans	0	14,140	14,140	0	131	131
Total commercial	6,774	344,170	350,944	941	3,165	4,106
Consumer	17	17,363	17,380	0	228	228
Unallocated						499
Total	\$8,078	\$ 814,454	\$822,532	\$ 1,059	\$ 7,257	\$ 8,815



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

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

(In Thousands)	September 30, 2018			December 31, 2017		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Unpaid Principal Balance	Recorded Investment	Related Allowance
With no related allowance recorded:						
Residential mortgage loans - first liens	\$753	\$ 724	\$ 0	\$740	\$ 711	\$ 0
Residential mortgage loans - junior liens	54	54	0	60	60	0
Commercial loans secured by real estate	1,605	1,605	0	3,230	3,230	0
Commercial and industrial	126	126	0	119	119	0
Loans secured by farmland	863	863	0	871	871	0
Multi-family (5 or more) residential	987	392	0	987	392	0
Agricultural loans	674	674	0	8	8	0
Consumer	17	17	0	20	20	0

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Total with no related allowance recorded	5,079	4,455	0	6,035	5,411	0
With a related allowance recorded:						
Residential mortgage loans - first liens	270	270	0	273	273	122
Residential mortgage loans - junior liens	239	239	118	242	242	0
Commercial loans secured by real estate	2,550	2,550	816	2,641	2,641	919
Commercial and industrial	75	75	75	449	449	188
Loans secured by farmland	489	489	50	495	495	50
Total with a related allowance recorded	3,623	3,623	1,059	4,100	4,100	1,279
Total	\$8,702	\$ 8,078	\$ 1,059	\$10,135	\$ 9,511	\$ 1,279

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

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

(In Thousands)	Average Investment in Impaired Loans				Interest Income Recognized on Impaired Loans on a Cash Basis			
	3 Months Ended		9 Months Ended		3 Months Ended		9 Months Ended	
	Sept. 30, 2018	2017	Sept. 30, 2018	2017	Sept. 30, 2018	2017	Sept. 30, 2018	2017
Residential mortgage:								
Residential mortgage loans - first lien	\$ 1,067	\$ 733	\$ 1,102	\$ 738	\$ 17	\$ 8	\$ 47	\$ 25
Residential mortgage loans - junior lien	295	64	298	65	3	1	10	3
Total residential mortgage	1,362	797	1,400	803	20	9	57	28
Commercial:								
Commercial loans secured by real estate	4,050	6,200	4,921	6,377	25	36	95	127
Commercial and industrial	184	393	346	317	4	13	11	20
Loans secured by farmland	1,355	1,378	1,359	1,382	11	10	27	32
Multi-family (5 or more) residential	392	392	392	392	0	0	0	0
Agricultural loans	677	10	512	11	16	0	34	1
Total commercial	6,658	8,373	7,530	8,479	56	59	167	180
Consumer	17	25	18	27	1	0	1	0
Total	\$ 8,037	\$ 9,195	\$ 8,948	\$ 9,309	\$ 77	\$ 68	\$ 225	\$ 208

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

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

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(In Thousands)	September 30, 2018		December 31, 2017	
	Past Due 90+ Days and Accruing	Nonaccrual	Past Due 90+ Days and Accruing	Nonaccrual
Residential mortgage:				
Residential mortgage loans - first liens	\$ 1,615	\$ 4,248	\$ 2,340	\$ 5,131
Residential mortgage loans - junior liens	137	239	105	242
Home equity lines of credit	102	27	203	44
Total residential mortgage	1,854	4,514	2,648	5,417
Commercial:				
Commercial loans secured by real estate	292	3,810	175	5,645
Commercial and industrial	708	155	603	517
Commercial construction and land	0	52	26	52
Loans secured by farmland	261	1,300	271	1,308
Multi-family (5 or more) residential	0	392	0	392
Agricultural loans	0	674	0	7
Total commercial	1,261	6,383	1,075	7,921
Consumer	9	14	1	66
Totals	\$ 3,124	\$ 10,911	\$ 3,724	\$ 13,404

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

The table below presents a summary of the contractual aging of loans as of September 30, 2018 and December 31, 2017:

(In Thousands)	As of September 30, 2018				As of December 31, 2017			
	Current & Past Due Less than 30 Days	Past Due 30-89 Days	Past Due 90+ Days	Total	Current & Past Due Less than 30 Days	Past Due 30-89 Days	Past Due 90+ Days	Total
Residential mortgage:								
Residential mortgage loans - first liens	\$359,582	\$ 3,320	\$ 3,614	\$366,516	\$347,032	\$7,967	\$4,988	\$359,987
Residential mortgage loans - junior liens	25,499	112	137	25,748	25,133	87	105	25,325
Home equity lines of credit	33,734	438	111	34,283	34,789	732	237	35,758
1-4 Family residential construction	27,340	321	0	27,661	25,667	549	0	26,216
Total residential mortgage	446,155	4,191	3,862	454,208	432,621	9,335	5,330	447,286
Commercial:								
Commercial loans secured by real estate	157,281	505	1,426	159,212	155,917	311	3,038	159,266
Commercial and industrial	90,661	36	775	91,472	87,306	303	667	88,276
Political subdivisions	53,294	0	0	53,294	59,287	0	0	59,287
Commercial construction and land	12,226	0	52	12,278	14,400	49	78	14,527
Loans secured by farmland	5,448	743	1,017	7,208	6,226	12	1,017	7,255
Multi-family (5 or more) residential	7,260	18	392	7,670	7,321	0	392	7,713
Agricultural loans	5,664	0	6	5,670	6,114	57	7	6,178
Other commercial loans	14,140	0	0	14,140	10,986	0	0	10,986
Total commercial	345,974	1,302	3,668	350,944	347,557	732	5,199	353,488
Consumer	17,309	48	23	17,380	14,760	123	56	14,939
Totals	\$809,438	\$ 5,541	\$ 7,553	\$822,532	\$794,938	\$10,190	\$10,585	\$815,713

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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, 2018 and December 31, 2017 is as follows:

(In Thousands)	Current & Past Due			Total
	Less than 30 Days	30-89 Days	Past Due 90+ Days	
September 30, 2018 Nonaccrual Totals	\$ 5,396	\$ 1,086	\$ 4,429	\$ 10,911
December 31, 2017 Nonaccrual Totals	\$ 5,802	\$ 741	\$ 6,861	\$ 13,404

Loans whose terms are modified are classified as Troubled Debt Restructurings (TDRs) if the Corporation grants such borrowers concessions, and it is deemed that those borrowers are experiencing financial difficulty. Loans classified as TDRs are designated as impaired. The outstanding balance of loans subject to TDRs, as well as contractual aging information at September 30, 2018 and December 31, 2017 is as follows:

(In Thousands)	Current & Past Due			Nonaccrual	Total
	Less than 30 Days	30-89 Days	Past Due 90+ Days		
September 30, 2018 Totals	\$ 597	\$ 101	\$ 0	\$ 2,925	\$ 3,623
December 31, 2017 Totals	\$ 636	\$ 0	\$ 0	\$ 3,027	\$ 3,663

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

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

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

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

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

(In Thousands)	Sept. 30, 2018	Dec. 31, 2017
Foreclosed residential real estate	\$ 328	\$ 721

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

(In Thousands)	Sept. 30, 2018	Dec. 31, 2017
Residential real estate in process of foreclosure	\$ 704	\$ 1,789

## 8. BORROWED FUNDS

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

(In Thousands)	Sept. 30, 2018	Dec. 31, 2017
FHLB-Pittsburgh borrowings	\$ 3,000	\$58,000
Customer repurchase agreements	5,421	3,766
Total short-term borrowings	\$ 8,421	\$61,766

The FHLB-Pittsburgh loan facilities are collateralized by qualifying loans secured by real estate with a book value totaling \$489,621,000 at September 30, 2018 and \$488,889,000 at December 31, 2017. Also, the FHLB-Pittsburgh loan facilities require the Corporation to invest in established amounts of FHLB-Pittsburgh stock. The carrying values of the Corporation's holdings of FHLB-Pittsburgh stock (included in Other Assets) were \$5,017,000 at September 30, 2018 and \$6,426,000 at December 31, 2017.

At September 30, 2018, the short-term borrowing from FHLB-Pittsburgh consisted of an advance of \$3,000,000 which matured in October 2018, with an interest rate of 1.83%. At December 31, 2017, the short-term borrowings from FHLB-Pittsburgh of \$58,000,000 included an overnight borrowing of \$29,000,000 with an interest rate of 1.54% and other short-term advances totaling \$29,000,000 with a weighted average rate of 1.69%.



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The Corporation engages in repurchase agreements with certain commercial customers. These agreements provide that the Corporation sells specified investment securities to the customers on an overnight basis and repurchases them on the following business day. The weighted average interest rate paid by the Corporation on customer repurchase agreements was 0.10% at September 30, 2018 and December 31, 2017. The carrying value of the underlying securities was \$10,099,000 at September 30, 2018 and \$12,158,000 at December 31, 2017.

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

(In Thousands)	Sept. 30, 2018	Dec. 31, 2017
Loan maturing in November 2018 with a rate of 1.63%	\$3,000	\$3,000
Loan maturing in December 2018 with a rate of 1.35%	3,000	3,000
Loan maturing in January 2019 with a rate of 1.83%	2,000	2,000
Loan maturing in February 2019 with a rate of 1.95%	3,000	0
Loan maturing in March 2019 with a rate of 2.15%	3,000	0
Loan maturing in April 2019 with a rate of 2.24%	3,000	0
Loan maturing in May 2019 with a rate of 2.30%	3,000	0
Loan maturing in June 2019 with a rate of 2.42%	3,000	0
Loan maturing in July 2019 with a rate of 2.41%	3,000	0
Loan maturing in August 2019 with a rate of 2.48%	3,000	0
Loan maturing in September 2019 with a rate of 2.53%	3,000	0
Loan maturing in April 2020 with a rate of 4.79%	320	463
Loan maturing in June 2025 with a rate of 4.91%	665	726
Total long-term FHLB-Pittsburgh borrowings	\$32,985	\$9,189

**9. DEFINED BENEFIT PLANS**

The Corporation sponsors a defined benefit health care plan that provides postretirement medical benefits and life insurance to employees who meet certain age and length of service requirements. Full-time employees no longer accrue service time toward the Corporation-subsidized portion of the medical benefits. The plan contains a cost-sharing feature which causes participants to pay for all future increases in costs related to benefit coverage. Accordingly, actuarial assumptions related to health care cost trend rates do not significantly affect the liability balance at September 30, 2018 and December 31, 2017 and are not expected to significantly affect the Corporation's future expenses. The Corporation uses a December 31 measurement date for the postretirement plan.

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

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

Defined Benefit Plans

(In Thousands)	Pension		Postretirement	
	Nine Months Ended		Nine Months Ended	
	Sept. 30,		Sept. 30,	
	2018	2017	2018	2017
Service cost	\$ 0	\$ 0	\$ 30	\$ 27
Interest cost	19	18	38	43
Expected return on plan assets	(15 )	(23 )	0	0
Amortization of prior service cost	0	0	(23 )	(23 )
Recognized net actuarial loss	10	5	0	0
Net periodic benefit cost	\$ 14	\$ 0	\$ 45	\$ 47

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(In Thousands)

	Pension		Postretirement	
	Three Months Ended		Three Months Ended	
	Sept. 30,		Sept. 30,	
	2018	2017	2018	2017
Service cost	\$ 0	\$ 0	\$ 10	\$ 9
Interest cost	6	6	12	15
Expected return on plan assets	(5 )	(8 )	0	0
Amortization of prior service cost	0	0	(7 )	(8 )
Recognized net actuarial loss	4	2	0	0
Net periodic benefit cost	\$ 5	\$ 0	\$ 15	\$ 16

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

In the first nine months of 2018, the Corporation funded postretirement contributions totaling \$35,000, with estimated annual postretirement contributions of \$60,000 expected in 2018 for the full year. No defined benefit pension contributions are required in 2018, though the Corporation may make discretionary contributions.

**10. STOCK-BASED COMPENSATION PLANS**

The Corporation has a Stock Incentive Plan for a selected group of officers and an Independent Directors Stock Incentive Plan. In the first quarter 2018, the Corporation awarded 25,466 shares of restricted stock under the Stock Incentive Plan and 9,086 shares of restricted stock under the Independent Directors Stock Incentive Plan. The 2018 restricted stock awards under the Stock Incentive Plan vest ratably over three years, and vesting for one-half of the 16,578 restricted shares awarded to Executive Officers depends on the Corporation meeting a return on average equity (“ROAE”) target each year. The 2018 restricted stock issued under the Independent Directors Stock Incentive Plan vests over one year.

Compensation cost related to restricted stock is recognized based on the fair value of the stock at the grant date over the vesting period, adjusted for estimated and actual forfeitures. Management has estimated restricted stock expense in the first nine months of 2018 based on an assumption that the ROAE target for awards to Executive Officers in 2016,

2017 and 2018 will not be met, resulting in forfeiture of the restricted stock.

Total annual stock-based compensation for the year ending December 31, 2018 is estimated to total \$664,000. If the ROAE targets for awards to Executive Officers in 2016, 2017 and 2018 are met or exceeded, total annual stock-based compensation would increase by approximately \$190,000. Total stock-based compensation expense attributable to restricted stock awards amounted to \$162,000 in the third quarter 2018 and \$500,000 in the nine-month period ended September 30, 2018. Total stock-based compensation expense attributable to restricted stock awards amounted to \$153,000 in the third quarter 2017 and \$475,000 in the nine-month period ended September 30, 2017.