

CITIZENS & NORTHERN CORP  
Form 10-K  
February 18, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2015

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: 0-16084

**CITIZENS & NORTHERN CORPORATION**

(Exact name of Registrant as specified in its charter)

|   |   |
|---|---|
| PENNSYLVANIA  | 23-2451943                              |
| (State or other jurisdiction of<br>incorporation or organization) | (I.R.S. Employer<br>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)

Securities registered pursuant to Section 12(b) of the Act:

| <b>Title of Each Class</b>    | <b>Name of Exchange Where Registered</b> |
|-------------------------------|--|
| Common Stock Par Value \$1.00 | The NASDAQ Stock Market LLC              |

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

(Check one:) Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

Yes  No

The aggregate market value of the registrant's common stock held by non-affiliates at June 30, 2015, the registrant's most recently completed second fiscal quarter, was \$244,570,133.

The number of shares of common stock outstanding at February 12, 2016 was 12,151,108.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's proxy statement for the annual meeting of its shareholders to be held April 21, 2016 are incorporated by reference into Parts III and IV of this report.

## **PART I**

### **ITEM 1. BUSINESS**

Citizens & Northern Corporation (“Corporation”) is a holding company whose principal activity is community banking. The Corporation’s principal office is located in Wellsboro, Pennsylvania. The largest subsidiary is Citizens & Northern Bank (“C&N Bank” or the “Bank”). The Corporation’s other wholly-owned subsidiaries are Citizens & Northern Investment Corporation and Bucktail Life Insurance Company (“Bucktail”). Citizens & Northern Investment Corporation was formed in 1999 to engage in investment activities. Bucktail reinsures credit and mortgage life and accident and health insurance on behalf of C&N Bank.

C&N Bank is a Pennsylvania banking institution that was formed by the consolidation of Northern National Bank of Wellsboro and Citizens National Bank of Towanda on October 1, 1971. Subsequent mergers included: First National Bank of Ralston in May 1972; Sullivan County National Bank in October 1977; Farmers National Bank of Athens in January 1984; and First National Bank of East Smithfield in May 1990. In 2005, the Corporation acquired Canisteo Valley Corporation and its subsidiary, First State Bank, a New York State chartered commercial bank with offices in Canisteo and South Hornell, NY. In 2010, the First State Bank operations were merged into C&N Bank and Canisteo Valley Corporation was merged into the Corporation. On May 1, 2007, the Corporation acquired Citizens Bancorp, Inc. (“Citizens”), with banking offices in Coudersport, Emporium and Port Allegany, Pennsylvania. Citizens Trust Company, the banking subsidiary of Citizens, was merged with and into C&N Bank as part of the transaction. C&N Bank has held its current name since May 6, 1975, at which time C&N Bank changed its charter from a national bank to a Pennsylvania bank.

C&N Bank provides an extensive range of banking services, including deposit and loan products for personal and commercial customers. The Bank also maintains a trust division that provides a wide range of financial services, such as 401(k) plans, retirement planning, estate planning, estate settlements and asset management. In January 2000, C&N Bank formed a subsidiary, C&N Financial Services Corporation (“C&NFSC”). C&NFSC is a licensed insurance agency that provides insurance products to individuals and businesses. In 2001, C&NFSC added a broker-dealer division, which offers mutual funds, annuities, educational savings accounts and other investment products through registered agents. C&NFSC’s operations are not significant in relation to the total operations of the Corporation.

All phases of the Bank’s business are competitive. The Bank primarily competes in Tioga, Bradford, Sullivan, Lycoming, Potter, Cameron and McKean counties in Pennsylvania, and Steuben and Allegany counties in New York. The Bank competes with local commercial banks headquartered in our market area as well as other commercial banks with branches in our market area. Some of the banks that have branches in our market area are larger in overall size. With respect to lending activities and attracting deposits, the Bank also competes with savings banks, savings and loan associations, insurance companies, regulated small loan companies and credit unions. Also, the Bank competes with

mutual funds for deposits. C&N Bank competes with insurance companies, investment counseling firms, mutual funds and other business firms and individuals for trust, investment management, brokerage and insurance services. The Bank is generally competitive with all financial institutions in our service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans. The Bank serves a diverse customer base, and is not economically dependent on any small group of customers or on any individual industry.

Major initiatives within the last 5 years included the following:

in 2011, sold the banking facility at 130 Court Street, Williamsport, PA, and entered into a leasing arrangement to continue to offer banking and trust services from the facility, resulting in an estimated \$122,000 (pre-tax) reduction in operating expenses in 2012;

in April 2012, re-opened the Athens, PA, facility, which was damaged by flooding in September 2011;

in 2013, worked with consultants on projects which resulted in increases in revenues from service charges on deposit accounts, starting primarily in the fourth quarter 2013, and reductions in electronic funds processing expenses and other benefits over approximately the next five years;

in 2014, approved a new treasury stock repurchase program. Under the new program, the Corporation is authorized to repurchase up to 622,500 shares of the Corporation's common stock, or approximately 5% of the Corporation's outstanding shares at July 16, 2014. Cumulatively through December 31, 2015, 435,200 shares had been repurchased; and

in 2015, began an organization-wide effort to enhance customer relationships, growth and profitability, including working with consultants on enhanced employee engagement and customer service training, and hiring four new lending personnel to provide more access to commercial and mortgage lending opportunities.

Virtually all of the Corporation's banking offices are located in the "Marcellus Shale," an area extending across portions of New York State, Pennsylvania, Ohio, Maryland, West Virginia and Virginia. In recent years, most of the Pennsylvania counties in which the Corporation operates were significantly affected by an upsurge in natural gas exploration, as technological developments made exploration of the Marcellus Shale commercially feasible. After a surge of activity in 2009 through most of 2011, the market price of natural gas declined, causing Marcellus Shale natural gas exploration activity to slow, though some activity has continued to occur throughout the Corporation's market area. Through December 31, 2015, the Corporation has not experienced significant credit issues as a result of the expansion and subsequent reduction in Marcellus Shale-related activity.

At December 31, 2015, C&N Bank had total assets of \$1,209,389,000, total deposits of \$942,331,000, net loans outstanding of \$696,991,000 and 283 full-time equivalent employees.

Most activities of the Corporation and its subsidiaries are regulated by federal or state agencies. The primary regulatory relationships are described as follows:

The Corporation is a bank holding company formed under the provisions of Section 3 of the Federal Reserve Act. The Corporation is under the direct supervision of the Federal Reserve and must comply with the reporting requirements of the Federal Bank Holding Company Act.

C&N Bank is a state-chartered, nonmember bank, supervised by the Federal Deposit Insurance Corporation and the Pennsylvania Department of Banking and Securities.

C&NFSC is a Pennsylvania corporation. The Pennsylvania Department of Insurance regulates C&NFSC's insurance activities. Brokerage products are offered through third party networking agreements.

Bucktail is incorporated in the state of Arizona and supervised by the Arizona Department of Insurance.

A copy of the Corporation's annual report on Form 10-K, quarterly reports on Form 10-Q, current events reports on Form 8-K, and amendments to these reports, will be furnished without charge upon written request to the Corporation's Treasurer at P.O. Box 58, Wellsboro, PA 16901. Copies of these reports will be furnished as soon as reasonably possible, after they are filed electronically with the Securities and Exchange Commission. The information is also available through the Corporation's web site at [www.cnbankpa.com](http://www.cnbankpa.com).

## **ITEM 1A. RISK FACTORS**

The Corporation is subject to the many risks and uncertainties applicable to all banking companies, as well as risks specific to the Corporation's geographic locations. Although the Corporation seeks to effectively manage risks, and maintains a level of equity that exceeds the banking regulatory agencies' thresholds for being considered "well capitalized" (see Note 18 to the consolidated financial statements), management cannot predict the future and cannot eliminate the possibility of credit, operational or other losses. Accordingly, actual results may differ materially from management's expectations. Some of the Corporation's significant risks and uncertainties are discussed below.

**Credit Risk from Lending Activities** - A significant source of risk is the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loan agreements. Most of the Corporation's loans are secured, but some loans are unsecured. With respect to secured loans, the collateral securing the repayment of these loans may be insufficient to cover the obligations owed under such loans. Collateral values may be adversely affected by changes in economic, environmental and other conditions, including declines in the value of real estate, changes in interest rates, changes in monetary and fiscal policies of the federal government, wide-spread disease, terrorist activity, environmental contamination and other external events. In addition, collateral appraisals that are out of date or that do not meet industry recognized standards may create the impression that a loan is adequately collateralized when it is not. The Corporation has adopted underwriting and credit monitoring procedures and policies, including regular reviews of appraisals and borrower financial statements, that management believes are appropriate to mitigate the risk of loss. Also, as discussed further in the "Provision and Allowance for Loan Losses" section of Management's Discussion and Analysis, the Corporation attempts to estimate the amount of losses that may be inherent in the portfolio through a quarterly evaluation process that includes several members of management and that addresses specifically identified problem loans, as well as other quantitative data and qualitative factors. Such risk management and accounting policies and procedures, however, may not prevent unexpected losses that could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

**Interest Rate Risk** - Business risk arising from changes in interest rates is an inherent factor in operating a banking organization. The Corporation's assets are predominantly long-term, fixed-rate loans and debt securities. Funding for these assets comes principally from shorter-term deposits and borrowed funds. Accordingly, there is an inherent risk of lower future earnings or decline in fair value of the Corporation's financial instruments when interest rates change. Significant fluctuations in interest rates could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity. For additional information regarding interest rate risk, see Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk."

**Breach of Information Security and Technology Dependence** - The Corporation relies on software, communication, and information exchange on a variety of computing platforms and networks and over the Internet. Despite numerous safeguards, the Corporation cannot be certain that all of its systems are entirely free from vulnerability to attack or other technological difficulties or failures. The Corporation relies on the services of a variety of vendors to meet its data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Corporation could be exposed to claims from customers. Any of these results could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

**Limited Geographic Diversification** - The Corporation grants commercial, residential and personal loans to customers primarily in the Pennsylvania counties of Tioga, Bradford, Sullivan, Lycoming, Potter, Cameron and McKean, and in Steuben and Allegany Counties in New York State. 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. Deterioration in economic conditions could adversely affect the quality of the Corporation's loan portfolio and the demand for its products and services, and accordingly, could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

**Competition** - All phases of the Corporation's business are competitive. Some competitors are much larger in total assets and capitalization than the Corporation, have greater access to capital markets and can offer a broader array of financial services. There can be no assurance that the Corporation will be able to compete effectively in its markets. Furthermore, developments increasing the nature or level of competition could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

**Government Regulation and Monetary Policy** - The Corporation and the banking industry are subject to extensive regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which the Corporation conducts its business, undertakes new investments and activities and obtains financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit the Corporation's shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is in the control of the Corporation. Significant new laws or changes in, or repeals of, existing laws could have a material adverse effect on the Corporation's financial condition, results of



operations or liquidity. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects short-term interest rates and credit conditions, and any unfavorable change in these conditions could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

**Mortgage Banking** – In September 2009, the Corporation entered into an agreement to originate and sell residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The Corporation's mortgage sales activity under this program was not significant in 2009, but has subsequently increased. In 2014, the Corporation entered into an agreement and in June 2014 began to originate and sell residential mortgage loans to the secondary market through the MPFX Original program, which is also administered by the Federal Home Loan Banks of Pittsburgh and Chicago. At December 31, 2015, total residential mortgages sold and serviced through the two programs amounted to \$152,448,000. The Corporation must strictly adhere to the MPF Xtra and MPFX Original program guidelines for origination, underwriting and servicing loans, and failure to do so may result in the Corporation being forced to repurchase loans or being dropped from the program. As of December 31, 2015, the total outstanding balance of residential mortgage loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to \$1,968,000. If the volume of such forced repurchases of loans were to increase significantly, or if the Corporation were to be dropped from the programs, it could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

**Debt Securities Risk** – In 2009, the Corporation’s earnings were materially impaired by securities losses. Much of the Corporation’s 2009 losses from trust-preferred securities and other securities stem from the much-publicized economic problems affecting the national and international economy, which particularly hurt the banking industry. The Corporation has exposure to the possibility of future losses from investments in obligations of states and political subdivisions (also known as municipal bonds) and other debt securities. For additional information regarding debt securities, see Note 7 to the consolidated financial statements.

The Federal Home Loan Bank of Pittsburgh - Through its subsidiary (C&N Bank), the Corporation is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 11 regional Federal Home Loan Banks. The Corporation has a line of credit with the FHLB-Pittsburgh that is secured by a blanket lien on its loan portfolio. Access to this line of credit is critical if a funding need arises. However, there can be no assurance that the FHLB-Pittsburgh will be able to provide funding when needed, nor can there be assurance that the FHLB-Pittsburgh will provide funds specifically to the Corporation should its financial condition deteriorate and/or regulators prevent that access. The inability to access this source of funds could have a materially adverse effect on the Corporation’s financial flexibility if alternate financing is not available at acceptable interest rates. The failure of the FHLB-Pittsburgh or the FHLB system in general, may materially impair the Corporation’s ability to meet short- and long-term liquidity needs or to meet growth plans.

The Corporation owns common stock of the FHLB-Pittsburgh in order to qualify for membership in the FHLB system and access services from the FHLB-Pittsburgh. The FHLB-Pittsburgh faces a variety of risks in its operations including interest rate risk, counterparty credit risk, and adverse changes in its regulatory framework. In addition, the 11 Federal Home Loan Banks are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB cannot meet its obligations, other FHLBs can be called upon to make required payments. Such risks affecting the FHLB-Pittsburgh could adversely impact the value of the Corporation’s investment in the common stock of the FHLB-Pittsburgh and/or affect its access to credit.

Soundness of Other Financial Institutions - In addition to the FHLB-Pittsburgh, the Corporation maintains other credit facilities that provide it with additional liquidity. These facilities include secured and unsecured borrowings from the Federal Reserve Bank and third-party commercial banks. The Corporation believes that it maintains a strong liquidity position and that it is well positioned to withstand foreseeable market conditions. However, legal agreements with counterparties typically include provisions allowing them to restrict or terminate the Corporation’s access to these credit facilities with or without advance notice and at their sole discretion.

Financial institutions are interconnected as a result of trading, clearing, counterparty, and other relationships. Financial market conditions have been negatively impacted in the past and such disruptions or adverse changes in the Corporation's results of operations or financial condition could, in the future, have a negative impact on available sources of liquidity. Such a situation may arise due to circumstances that are outside the Corporation’s control, such as general market disruptions or operational problems affecting the Corporation or third parties. The Corporation’s efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated

reductions in available liquidity. In such events, the Corporation's cost of funds may increase, thereby reducing net interest income, or the Corporation may need to sell a portion of its securities and/or loan portfolio, which, depending upon market conditions, could necessitate realizing a loss.

**FDIC Insurance Assessments** - In 2008 and 2009, higher levels of bank failures dramatically increased the resolution costs of the Federal Deposit Insurance Corporation, or the FDIC, and depleted the deposit insurance fund. In addition, the FDIC and the U.S. Congress increased federal deposit insurance coverage, placing additional stress on the deposit insurance fund. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund, in 2009 the FDIC increased assessment rates. Although our total expenses from FDIC assessments have steadily decreased – to \$600,000 in 2014 (up slightly to \$603,000 in 2015) from \$2,092,000 in 2009, we are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If a significant number of bank or financial institution failures occur, we may be required to pay higher FDIC premiums. Future increases in FDIC insurance premiums or additional special assessments may materially adversely affect our results of operations.

**Bank Secrecy Act and Related Laws and Regulations** - These laws and regulations have significant implications for all financial institutions. They increase due diligence requirements and reporting obligations for financial institutions, create new crimes and penalties, and require the federal banking agencies, in reviewing merger and other acquisition transactions, to consider the effectiveness of the parties to such transactions in combating money laundering activities. Even innocent noncompliance and inconsequential failure to follow the regulations could result in significant fines or other penalties, which could have a material adverse impact on the Corporation's financial condition, results of operations or liquidity.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

The Bank owns each of its properties, except for the branch facilities located at 130 Court Street, Williamsport, PA, and at 2 East Mountain Avenue, South Williamsport, PA, which are leased. All of the properties are in good condition. None of the owned properties are subject to encumbrance.

A listing of properties is as follows:

Main administrative offices:

90-92 Main Street or 10 Nichols Street  
Wellsboro, PA 16901 Wellsboro, PA 16901

Branch offices – Citizens & Northern Bank:

|  |                                      |   |
|--|--------------------------------------|---|
| 428 S. Main Street<br>Athens, PA 18810 | 514 Main Street<br>Laporte, PA 18626 | 2 East Mountain Avenue **<br>South Williamsport, PA 17702 |
|--|--------------------------------------|---|

|   |  |                                   |
|---|--|-----------------------------------|
| 10 North Main Street<br>Coudersport, PA 16915 | 4534 Williamson Trail<br>Liberty, PA 16930 | 41 Main Street<br>Tioga, PA 16946 |
|---|--|-----------------------------------|

|   |  |                                      |
|---|--|--------------------------------------|
| 111 W. Main Street<br>Dushore, PA 18614 | 1085 S. Main Street<br>Mansfield, PA 16933 | 428 Main Street<br>Towanda, PA 18848 |
|---|--|--------------------------------------|

|  |  |                                    |
|--|--|------------------------------------|
| 563 Main Street<br>East Smithfield, PA 18817 | 612 James Monroe Avenue<br>Monroeton, PA 18832 | 64 Elmira Street<br>Troy, PA 16947 |
|--|--|------------------------------------|

|   |   |  |
|---|---|--|
| 104 W. Main Street<br>Elkland, PA 16920 | 3461 Route 405 Highway<br>Muncy, PA 17756 | 90-92 Main Street<br>Wellsboro, PA 16901 |
|---|---|--|

|  |   |   |
|--|---|---|
| 135 East Fourth Street<br>Emporium, PA 15834 | 100 Maple Street<br>Port Allegany, PA 16743 | 1510 Dewey Avenue<br>Williamsport, PA 17701 |
|--|---|---|

230 Railroad Street  
Jersey Shore, PA 17740

24 Thompson Street  
Ralston, PA 17763

130 Court Street \*\*  
Williamsport, PA 17701

102 E. Main Street  
Knoxville, PA 16928

1827 Elmira Street  
Sayre, PA 18840

1467 Golden Mile Road  
Wysox, PA 18854

3 Main Street  
Canisteo, NY 14823

6250 County Rte 64  
Hornell, NY 14843

Facilities management office:

13 Water Street

Wellsboro, PA 16901

\*\* designates leased branch facility

### **ITEM 3. LEGAL PROCEEDINGS**

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

### **ITEM 4. MINE SAFETY DISCLOSURE**

Not applicable.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****QUARTERLY SHARE DATA**

Trades of the Corporation's stock are executed through various brokers who maintain a market in the Corporation's stock. The Corporation's stock is listed on the NASDAQ Capital Market with the trading symbol CZNC. As of December 31, 2015, there were 2,316 shareholders of record of the Corporation's common stock.

The following table sets forth the high and low sales prices of the common stock during 2015 and 2014.

|                | 2015    |         |  | 2014    |         |  |
|----------------|---------|---------|--|---------|---------|--|
|                | High    | Low     | Dividend<br>Declared<br>per<br>Quarter | High    | Low     | Dividend<br>Declared<br>per<br>Quarter |
| First quarter  | \$21.50 | \$19.01 | \$ 0.26                                | \$20.74 | \$18.19 | \$ 0.26                                |
| Second quarter | 21.17   | 19.16   | 0.26                                   | 20.10   | 17.94   | 0.26                                   |
| Third quarter  | 20.73   | 19.25   | 0.26                                   | 20.10   | 18.50   | 0.26                                   |
| Fourth quarter | 21.45   | 19.07   | 0.26                                   | 21.49   | 18.83   | 0.26                                   |

Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. Also, the Corporation and C&N Bank are subject to restrictions on the amount of dividends that may be paid without approval of banking regulatory authorities. These restrictions are described in Note 18 to the consolidated financial statements.

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

Consistent with previous programs, the Board of Directors' July 17, 2014 authorization provides that: (1) the new treasury stock repurchase program shall be effective when publicly announced and shall continue thereafter until suspended or terminated by the Board of Directors, in its sole discretion; and (2) all shares of common stock repurchased pursuant to

the new program shall be held as treasury shares and be available for use and reissuance for purposes as and when determined by the Board of Directors including, without limitation, pursuant to the Corporation's Dividend Reinvestment and Stock Purchase Plan and its equity compensation program. Through December 31, 2015, 435,200 shares had been repurchased at a cost of \$8,417,000.

The following table sets forth a summary of purchases by the Corporation, in the open market, of its equity securities during the fourth quarter 2015:

| Period                | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|-----------------------|----------------------------------|------------------------------|--|--|
| October 1 - 31, 2015  | 8,000                            | \$ 19.41                     | 419,400  | 203,100  |
| November 1 - 30, 2015 | 13,700                           | \$ 19.98                     | 433,100  | 189,400  |
| December 1 - 31, 2015 | 2,100                            | \$ 20.01                     | 435,200  | 187,300  |

**PERFORMANCE GRAPH**

Set forth below is a chart comparing the Corporation's cumulative return to stockholders against the cumulative return of the Russell 2000 and a Peer Group Index of similar banking organizations selected by the Corporation for the five-year period commencing December 31, 2010 and ended December 31, 2015. The index values are market-weighted dividend-reinvestment numbers, which measure the total return for investing \$100.00 five years ago. This meets Securities & Exchange Commission requirements for showing dividend reinvestment share performance over a five-year period and measures the return to an investor for placing \$100.00 into a group of bank stocks and reinvesting any and all dividends into the purchase of more of the same stock for which dividends were paid.

| Index                           | Period Ending |          |          |          |          |          |
|---------------------------------|---------------|----------|----------|----------|----------|----------|
|                                 | 12/31/10      | 12/31/11 | 12/31/12 | 12/31/13 | 12/31/14 | 12/31/15 |
| Citizens & Northern Corporation | 100.00        | 128.69   | 137.49   | 157.68   | 166.63   | 178.31   |
| Russell 2000                    | 100.00        | 95.82    | 111.49   | 154.78   | 162.35   | 155.18   |
| CZNC Peer Group Index*          | 100.00        | 93.86    | 112.37   | 140.86   | 154.64   | 162.21   |



The Corporation's peer group consists of banks headquartered in Pennsylvania with total assets of \$700 million to \$2 billion as of September 30, 2015. This peer group consists of ACNB Corporation, Gettysburg; AmeriServ Financial, Inc., Johnstown; CB Financial Services, Inc., Carmichaels; Citizens Financial Services, Inc., Mansfield; Codorus Valley Bancorp, Inc., York; DNB Financial Corporation, Downingtown; ENB Financial Corp., Ephrata; ESSA Bancorp, Inc., Stroudsburg; Fidelity D&D Bancorp, Inc., Dunmore; First Keystone Corporation, Berwick; First National Community Bancorp, Inc., Dunmore; FNB Bancorp, Inc., Newtown; Fox Chase Bancorp, Inc., Hatboro; Franklin Financial Services Corporation, Chambersburg; Harleysville Savings Financial Corporation, Harleysville; Norwood Financial Corp., Honesdale; Orrstown Financial Services, Inc., Shippensburg; Penns Woods Bancorp, Inc., Williamsport; Peoples Financial Services Corp., Scranton; QNB Corp., Quakertown; Republic First Bancorp, Inc., Philadelphia; Royal Bancshares of Pennsylvania, Inc., Bala Cynwyd; Somerset Trust Holding Company, Somerset; 1<sup>st</sup> Summit Bancorp of Johnstown, Inc., Johnstown; Mid Penn Bancorp, Inc., Millersburg; Embassy Bancorp, Inc., Bethlehem.

The data for this graph was obtained from SNL Financial LC, Charlottesville, VA.

## EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth information concerning the Stock Incentive Plan and Independent Directors Stock Incentive Plan, both of which have been approved by the Corporation's shareholders. The figures shown in the table below are as of December 31, 2015.

|  | Number of Securities to be Issued Upon Exercise of Outstanding Options | Weighted-average Price of Outstanding Options | Number of Securities Remaining for Future Issuance Under Equity Compensation Plans |
|--|--|---|--|
| Equity compensation plans approved by shareholders     | 248,486  | \$ 18.59                                      | 323,977  |
| Equity compensation plans not approved by shareholders | 0  | N/A   | 0  |

More details related to the Corporation's equity compensation plans are provided in Notes 1 and 13 to the consolidated financial statements.

**ITEM 6. SELECTED FINANCIAL DATA****As of or for the Year Ended December 31,**

|  |            |            |            |            |            |
|--|------------|------------|------------|------------|------------|
| INCOME STATEMENT (In Thousands)                              | 2015       | 2014       | 2013       | 2012       | 2011       |
| Interest and fee income                                      | \$44,519   | \$46,009   | \$48,914   | \$56,632   | \$61,256   |
| Interest expense   | 4,602      | 5,122      | 5,765      | 9,031      | 13,556     |
| Net interest income  | 39,917     | 40,887     | 43,149     | 47,601     | 47,700     |
| Provision (credit) for loan losses                           | 845        | 476        | 2,047      | 288        | (285)      |
| Net interest income after provision (credit) for loan losses | 39,072     | 40,411     | 41,102     | 47,313     | 47,985     |
| Noninterest income excluding securities gains                | 15,404     | 15,420     | 16,451     | 16,383     | 13,897     |
| Net impairment losses recognized in earnings from            |            |            |            |            |            |
| available-for-sale securities                                | 0          | 0          | (25)       | (67)       | 0          |
| Net realized gains on available-for-sale securities          | 2,861      | 1,104      | 1,743      | 2,749      | 2,216      |
| Loss on prepayment of debt                                   | 2,573      | 0          | 1,023      | 2,333      | 0          |
| Noninterest expense excluding loss on prepayment of debt     | 32,956     | 34,157     | 33,471     | 32,914     | 32,016     |
| Income before income tax provision                           | 21,808     | 22,778     | 24,777     | 31,131     | 32,082     |
| Income tax provision   | 5,337      | 5,692      | 6,183      | 8,426      | 8,714      |
| Net income   | \$16,471   | \$17,086   | \$18,594   | \$22,705   | \$23,368   |
| PER COMMON SHARE:  |            |            |            |            |            |
| Basic earnings per share                                     | \$1.35     | \$1.38     | \$1.51     | \$1.86     | \$1.92     |
| Diluted earnings per share                                   | \$1.35     | \$1.38     | \$1.50     | \$1.85     | \$1.92     |
| Cash dividends declared per share                            | \$1.04     | \$1.04     | \$1.00     | \$0.84     | \$0.58     |
| Book value per common share at period-end                    | \$15.39    | \$15.34    | \$14.49    | \$14.89    | \$13.77    |
| Tangible book value per common share at period-end           | \$14.41    | \$14.36    | \$13.51    | \$13.91    | \$12.77    |
| Weighted average common shares outstanding - basic           | 12,211,941 | 12,390,067 | 12,352,383 | 12,235,748 | 12,162,045 |
| Weighted average common shares outstanding - diluted         | 12,233,773 | 12,412,050 | 12,382,790 | 12,260,208 | 12,166,768 |
| END OF PERIOD BALANCES (In Thousands)                        |            |            |            |            |            |
| Available-for-sale securities                                | \$420,290  | \$516,807  | \$482,658  | \$472,577  | \$481,685  |
| Gross loans  | 704,880    | 630,545    | 644,303    | 683,910    | 708,315    |
| Allowance for loan losses                                    | 7,889      | 7,336      | 8,663      | 6,857      | 7,705      |
| Total assets   | 1,223,417  | 1,241,963  | 1,237,695  | 1,286,907  | 1,323,735  |
| Deposits   | 935,615    | 967,989    | 954,516    | 1,006,106  | 1,018,206  |
| Borrowings   | 92,263     | 78,597     | 96,723     | 89,379     | 130,313    |
| Stockholders' equity   | 187,487    | 188,362    | 179,472    | 182,786    | 167,385    |

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|                                 |            |            |            |            |            |
|---------------------------------|------------|------------|------------|------------|------------|
| Common shares outstanding       | 12,180,623 | 12,279,980 | 12,390,063 | 12,274,035 | 12,155,529 |
| AVERAGE BALANCES (In Thousands) |            |            |            |            |            |
| Total assets                    | 1,243,209  | 1,239,897  | 1,237,096  | 1,305,163  | 1,313,445  |
| Earning assets                  | 1,159,298  | 1,155,401  | 1,145,340  | 1,199,538  | 1,208,584  |
| Gross loans                     | 657,727    | 627,753    | 656,495    | 700,241    | 714,421    |
| Deposits                        | 968,201    | 965,418    | 964,031    | 1,008,469  | 1,001,125  |
| Stockholders' equity            | 188,905    | 185,469    | 181,412    | 175,822    | 152,718    |

**ITEM 6. SELECTED FINANCIAL DATA (Continued)****As of or for the Year Ended December 31,**

|   | 2015    | 2014    | 2013    | 2012    | 2011    |
|---|---------|---------|---------|---------|---------|
| <b>KEY RATIOS</b>                                   |         |         |         |         |         |
| Return on average assets                            | 1.32 %  | 1.38 %  | 1.50 %  | 1.74 %  | 1.78 %  |
| Return on average equity                            | 8.72 %  | 9.21 %  | 10.25 % | 12.91 % | 15.30 % |
| Average equity to average assets                    | 15.19 % | 14.96 % | 14.66 % | 13.47 % | 11.63 % |
| Net interest margin (1)                             | 3.69 %  | 3.80 %  | 4.05 %  | 4.26 %  | 4.22 %  |
| Efficiency (2)                                      | 56.60 % | 57.59 % | 53.27 % | 48.82 % | 49.37 % |
| Cash dividends as a % of diluted earnings per share | 77.04 % | 75.36 % | 66.67 % | 45.41 % | 30.21 % |
| Tier 1 leverage                                     | 14.31 % | 13.89 % | 13.78 % | 12.53 % | 10.93 % |
| Tier 1 risk-based capital                           | 23.40 % | 26.26 % | 25.15 % | 22.86 % | 19.95 % |
| Total risk-based capital                            | 24.45 % | 27.60 % | 26.60 % | 24.01 % | 21.17 % |
| Tangible common equity/tangible assets              | 14.49 % | 14.34 % | 13.66 % | 13.39 % | 11.84 % |
| Nonperforming assets/total assets                   | 1.31 %  | 1.34 %  | 1.53 %  | 0.82 %  | 0.73 %  |
| Nonperforming loans/total loans                     | 2.09 %  | 2.45 %  | 2.80 %  | 1.41 %  | 1.19 %  |
| Allowance for loan losses/total loans               | 1.12 %  | 1.16 %  | 1.34 %  | 1.00 %  | 1.09 %  |
| Net charge-offs/average loans                       | 0.04 %  | 0.29 %  | 0.04 %  | 0.16 %  | 0.16 %  |

(1) Rates of return on tax-exempt securities and loans are calculated on a fully-taxable equivalent basis.

(2) The efficiency ratio is calculated by dividing: (a) total noninterest expense excluding losses from prepayment of debt, by (b) the sum of net interest income (including income from tax-exempt securities and loans on a fully-taxable equivalent basis) and noninterest income excluding securities gains or losses.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

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

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

### **EARNINGS OVERVIEW**

In 2015, net income totaled \$16,471,000, or \$1.35 per common share - basic and diluted, as compared to \$1.38 per share – basic and diluted in 2014 and \$1.51 per share basic and \$1.50 per share – diluted in 2013. The results for 2015 represented a return on average assets of 1.32% and a return on average equity of 8.72%.

#### **2015 vs. 2014**

Net income per share – diluted for 2015 was 2.2% lower than in 2014. Some of the more significant highlights related to annual earnings in 2015 as compared to 2014 are as follows:

Net interest income totaled \$39,917,000 in 2015, down \$970,000 (2.4%) from 2014. In 2015, yields earned on securities and loans fell by more than the corresponding drop in interest rates paid on deposits and borrowings. The net interest margin was 3.69% in 2015, down from 3.80% in 2014.

The provision for loan losses was \$845,000 in 2015, up from \$476,000 in 2014. The higher 2015 provision for loan losses reflected an increase in outstanding loans in the year which resulted in an increase in the collectively determined portion of the allowance for loan losses. Gross loans at December 31, 2015 were \$74.3 million, or 11.8%, higher than the balance a year earlier.

In 2015, noninterest revenue, excluding net realized gains on available-for-sale securities, totaled \$15,404,000, which was down slightly from \$15,420,000 in 2014. The most significant changes in components of noninterest revenue for the year ended December 31, 2015 as compared to the corresponding period in 2014 included the following: (1) decrease of \$161,000 (3.2%) in service charges on deposit accounts, primarily as a result of lower overdraft fees; (2) reduction of \$135,000 as the fair value of servicing rights declined \$162,000 in 2015 as compared to \$27,000 in 2014; (3) net increase in revenues from Trust and brokerage services of \$74,000 (1.4%); and (4) an increase in other operating income of \$315,000, including a gain of \$212,000 from a life insurance arrangement in which benefits were split between the Corporation and the heirs of a former employee as well as an increase of \$36,000 in dividends from Federal Home Loan Bank of Pittsburgh stock and an increase of \$28,000 in revenue from merchant services.

Realized gains from available-for-sale securities totaled \$2,861,000 and losses from prepayment of borrowings totaled \$2,573,000 in 2015, while in 2014 realized gains from securities totaled \$1,104,000 and there were no losses from prepayment of borrowings. In 2015, the Corporation sold a significant portion of its marketable equity securities portfolio, which was made up of bank stocks, generating realized gains of \$2,220,000. Losses from prepayment of borrowings stemmed from pay-downs made in May and December 2015 totaling \$34,000,000 on a long-term repurchase agreement with an interest rate of 4.265%. After the effects of these pay-downs, there was no balance outstanding on this repurchase agreement as of December 31, 2015. Management expects the combined result of the debt prepayments and reinvestment of proceeds from sales of stocks will make a positive contribution to net interest income in 2016.

In 2015, noninterest expenses, excluding losses on prepayment of borrowings; totaled \$32,956,000, which was \$1,201,000 (3.5%) lower than total 2014 noninterest expenses. The reduction in noninterest expenses for the year ended December 31, 2015 as compared to the corresponding period in 2014 included the following: (1) a reduction in salaries and wages expenses of \$439,000, mainly due to severance expenses in 2014; (2) a reduction in employee benefit-related expenses of \$349,000 due to lower employee health insurance expense as a result of lower claims; (3) a reduction in Pennsylvania shares tax expense of \$176,000, reflecting an increase in tax credits; (4) a reduction in professional fees expense of \$161,000, as 2014 included expenses associated with an executive search; and (5) a reduction in other expenses of \$182,000, including reductions in expenses from loan collections and other real estate properties.

## **2014 vs. 2013**

Net income per share – diluted for 2014 was 8.0% lower than in 2013. Some of the more significant highlights related to annual earnings in 2014 as compared to 2013 are as follows:

Net interest income totaled \$40,887,000 in 2014, down \$2,262,000 (5.2%) from 2013. In 2014, yields earned on securities and loans fell by more than the corresponding drop in interest rates paid on deposits and borrowings. Also, average total loans outstanding were 4.3% lower in 2014 as compared to 2013. The net interest margin was 3.80% in 2014, down from 4.05% in 2013.

The provision for loan losses was \$476,000 in 2014, down from \$2,047,000 in 2013. The higher levels of expense in 2013 included a provision of \$1,552,000 from loans to one commercial customer.

In 2014, noninterest revenue, excluding net realized gains on available-for-sale securities, totaled \$15,420,000, which was lower than the 2013 amount by \$1,031,000 (6.3%). Gains from sales of residential mortgage loans totaled \$768,000 in 2014, down from \$1,969,000 in 2013, reflecting lower volume from refinancing activity. Service charges on deposit accounts fell \$221,000 in 2014 as compared to 2013, a decline of 4.2%, primarily as a result of lower net overdraft fees. Total Trust and brokerage revenue of \$5,391,000 in 2014 was \$520,000 (10.7%) higher than in 2013.

Realized gains from available-for-sale securities totaled \$1,104,000 in 2014, while in 2013 realized gains from securities totaled \$1,718,000 and losses from prepayment of borrowings totaled \$1,023,000.

In 2014, noninterest expenses totaled \$34,157,000, which was \$686,000 (2.0%) higher than total 2013 noninterest expenses, excluding the loss on prepayment of borrowings. Salaries and wages expense increased \$915,000 in 2014 as compared to 2013, mainly as a result of severance benefits. Pensions and other employee benefit expenses increased \$619,000, mainly due to higher health care costs and a charge related to a distribution from a defined benefit pension plan. Professional fees expense was \$835,000 lower in 2014 as compared to 2013, as the total in 2013 included fees associated with projects designed to identify sources of noninterest revenue and reductions in debit card and ATM processing expense.

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

### **CRITICAL ACCOUNTING POLICIES**

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



A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses. 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. Management believes the allowance for loan losses is adequate and reasonable. Notes 1 and 8 to the consolidated financial statements provide an overview of the process management uses for evaluating and determining the allowance for loan losses, and additional discussion of the allowance for loan losses is provided in a separate section later in Management's Discussion and Analysis. Given the very subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

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

As described in Note 7 to the consolidated financial statements, management evaluates securities for other-than-temporary impairment ("OTTI"). In making that evaluation, consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security or more likely than not will be required to sell the security before its anticipated recovery. Management's assessments of the likelihood and potential for recovery in value of securities are subjective and based on sensitive assumptions.

## **NET INTEREST INCOME**

The Corporation's primary source of operating income is net interest income, which is equal to the difference between the amounts of interest income and interest expense. Tables I, II and III include information regarding the Corporation's net interest income in 2015, 2014, and 2013. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest income amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the tables.

**2015 vs. 2014**

Fully taxable equivalent net interest income was \$42,819,000 in 2015, which was \$1,074,000 (2.4%) lower than in 2014. As shown in Table III, in 2015 compared to 2014, interest rate changes had the effect of decreasing net interest income \$2,283,000, and net changes in volume had the effect of increasing net interest income \$1,209,000. The most significant components of the rate-related change in net interest income in 2015 were a decrease in interest income of \$1,957,000 attributable to lower rates earned on loans receivable and a decrease of \$468,000 in interest income on available-for-sale securities. The most significant components of the volume-related increase in net interest income in 2015 was an increase in interest income of \$1,544,000 attributable to an increase in the balance of loans receivable, a decrease in interest expense of \$270,000 attributable to a reduction in the balance of borrowed funds, and a decrease in interest expense of \$117,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit), partially offset by a volume-related decrease in interest income on available-for-securities of \$681,000. As presented in Table II, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.54% in 2015 as compared to 3.63% in 2014.

**INTEREST INCOME AND EARNING ASSETS**

Interest income totaled \$47,421,000 in 2015, a decrease of 3.2% from 2014. Interest and fees on loans receivable decreased \$413,000, or 1.2%. As indicated in Table II, average available-for-sale securities (at amortized cost) totaled \$479,148,000 in 2015, a decrease of \$15,786,000 (3.2%) from 2014. The net decrease in the Corporation's available-for-sale securities portfolio consisted of decreases in tax-exempt municipal securities, U.S. Government mortgage-backed securities, U.S. Government agency bonds, and equity securities. These decreases were partially offset by increases in the balances of collateralized mortgage obligations and taxable municipal securities. The Corporation's yield on securities was lower in 2015 than in 2014, primarily because of low market interest rates on new investments combined with higher-yielding securities maturing. The average rate of return on available-for-sale securities was 2.81% for 2015 and 2.95% in 2014.

The average balance of gross loans receivable increased 4.8% to \$657,727,000 in 2015 from \$627,753,000 in 2014. The Corporation experienced growth in the balances of tax free municipal loans, residential mortgages and participation loans purchased. These increases were partially offset by decreases in balances of commercial real estate loans. The Corporation's average rate of return on loans receivable declined to 5.15% in 2015 from 5.46% in 2014.

The average balance of interest-bearing due from banks decreased to \$22,201,000 in 2015 from \$32,510,000 in 2014. This has consisted primarily of balances held by the Federal Reserve and also includes other overnight deposits and FDIC-insured certificates of deposit issued by other financial institutions.

#### INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell \$520,000, or 10.2%, to \$4,602,000 in 2015 from \$5,122,000 in 2014. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 0.55% in 2015 from 0.61% in 2014.

Total average deposits (interest-bearing and noninterest-bearing) increased 0.3%, to \$968,201,000 in 2015 from \$965,418,000 in 2014. Decreases in the average balances of certificates of deposit, Individual Retirement Accounts, and money market accounts were partially offset by increases in average balances of interest checking, savings accounts and non-interest bearing demand deposits. The average rate paid on interest-bearing deposits fell slightly to 0.26% in 2015 from 0.28% in 2014.

Total average borrowed funds decreased \$2,298,000 to \$77,642,000 in 2015 from \$79,940,000 in 2014. The average rate on borrowed funds was 3.45% in 2015 compared to 3.70% in 2014, reflecting a \$6,982,000 reduction in the average balance of higher-rate, long-term borrowings resulting from pre-payment of a long-term repurchase agreement borrowing with an interest rate of 4.265%. The Corporation paid off \$10 million of principal on this borrowing in May 2015, and \$24 million in December 2015, leaving no remaining balance outstanding at December 31, 2015. (The pre-payment of long-term borrowings is described in the Earnings Overview section.) The average balance of short-term borrowings increased \$4,684,000 in 2015 over 2014, as average overnight borrowings were higher in 2015 and the Corporation funded the pay-off of the long-term repurchase agreement in December 2015 with funds from a series of short-term advances from the FHLB-Pittsburgh totaling \$25,072,000 and an average rate of 0.86%.

#### 2014 vs. 2013

Fully taxable equivalent net interest income was \$43,893,000 in 2014, which was \$2,491,000 (5.3%) lower than in 2013. As shown in Table III, in 2014 compared to 2013, interest rate changes had the effect of decreasing net interest income \$1,622,000, and net changes in volume had the effect of decreasing net interest income \$869,000. The most significant component of the rate-related change in net interest income in 2014 was a decrease in interest income of \$1,718,000 attributable to lower rates earned on loans receivable. The most significant components of the volume-related decrease in net interest income in 2014 were a decrease in interest income of \$1,602,000 attributable to a decline in the balance of loans receivable, partially offset by a volume-related increase in interest income on available-for-securities of \$499,000, a decrease in interest expense of \$161,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit) and a decrease in interest expense of \$109,000 attributable to a reduction in the balance of borrowed funds. As presented in Table II, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.63% in 2014 as compared to 3.88% in 2013.

## INTEREST INCOME AND EARNING ASSETS

Interest income totaled \$49,015,000 in 2014, a decrease of 6.0% from 2013. Interest and fees on loans receivable decreased \$3,320,000, or 8.8%. As indicated in Table II, average available-for-sale securities (at amortized cost) totaled \$494,934,000 in 2014, an increase of \$33,370,000 (7.2%) from 2013. Net increase in the Corporation's available-for-sale securities portfolio was primarily made up of U.S. Government agency mortgage-backed securities and collateralized mortgage obligations. This increase was partially offset by decreases in the balances of U.S. Government agency bonds. The Corporation's yield on securities was lower in 2014 than in 2013, primarily because of low market interest rates. The average rate of return on available-for-sale securities was 2.95% for 2014 and 3.12% in 2013.

The average balance of gross loans receivable decreased 4.3% to \$627,753,000 in 2014 from \$656,495,000 in 2013. The Corporation experienced contraction in the balance of loans receivable due to borrowers prepaying or refinancing existing loans combined with modest demand for new loans. The decline in the balance of the residential mortgage portfolio was also affected by management's decision to sell a significant portion of newly originated residential mortgages on the secondary market. The Corporation's average rate of return on loans receivable declined to 5.46% in 2014 from 5.73% in 2013.

The average balance of interest-bearing due from banks increased to \$32,510,000 in 2014 from \$26,159,000 in 2013. This has consisted primarily of balances held by the Federal Reserve and also includes other overnight deposits and FDIC-insured certificates of deposit issued by other financial institutions.

#### INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell \$643,000, or 11.1%, to \$5,122,000 in 2014 from \$5,765,000 in 2013. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 0.61% in 2014 from 0.67% in 2013.

Total average deposits (interest-bearing and noninterest-bearing) increased 0.1%, to \$965,418,000 in 2014 from \$964,031,000 in 2013. Decreases in the average balances of certificates of deposit, Individual Retirement Accounts, and money market accounts were partially offset by increases in average balances of interest checking, savings accounts and non-interest bearing demand deposits. Consistent with continuing low short-term market interest rates, the average rates incurred on certificates of deposit and Individual Retirement Accounts have continued to decrease in 2014 as compared to 2013.

Total average borrowed funds decreased \$2,388,000 to \$79,940,000 in 2014 from \$82,328,000 in 2013. The average rate on borrowed funds was 3.70% in 2014, compared to 3.72% in 2013.

TABLE I - ANALYSIS OF INTEREST INCOME  
AND EXPENSE

| (In Thousands)                      | Years Ended December 31, |          |          | Increase/(Decrease) |            |
|-------------------------------------|--------------------------|----------|----------|---------------------|------------|
|                                     | 2015                     | 2014     | 2013     | 2015/2014           | 2014/2013  |
| <b>INTEREST INCOME</b>              |                          |          |          |                     |            |
| Available-for-sale securities:      |                          |          |          |                     |            |
| Taxable                             | \$7,587                  | \$8,028  | \$7,105  | \$(441 )            | \$ 923     |
| Tax-exempt                          | 5,869                    | 6,577    | 7,296    | (708 )              | (719 )     |
| Total available-for-sale securities | 13,456                   | 14,605   | 14,401   | (1,149 )            | 204        |
| Interest-bearing due from banks     | 93                       | 125      | 105      | (32 )               | 20         |
| Loans held for sale                 | 16                       | 16       | 54       | 0                   | (38 )      |
| Loans receivable:                   |                          |          |          |                     |            |
| Taxable                             | 31,311                   | 32,127   | 35,484   | (816 )              | (3,357 )   |
| Tax-exempt                          | 2,545                    | 2,142    | 2,105    | 403                 | 37         |
| Total loans receivable              | 33,856                   | 34,269   | 37,589   | (413 )              | (3,320 )   |
| Total Interest Income               | 47,421                   | 49,015   | 52,149   | (1,594 )            | (3,134 )   |
| <b>INTEREST EXPENSE</b>             |                          |          |          |                     |            |
| Interest-bearing deposits:          |                          |          |          |                     |            |
| Interest checking                   | 214                      | 216      | 211      | (2 )                | 5          |
| Money market                        | 299                      | 286      | 290      | 13                  | (4 )       |
| Savings                             | 128                      | 121      | 117      | 7                   | 4          |
| Certificates of deposit             | 831                      | 1,069    | 1,522    | (238 )              | (453 )     |
| Individual Retirement Accounts      | 451                      | 470      | 562      | (19 )               | (92 )      |
| Other time deposits                 | 1                        | 1        | 1        | 0                   | 0          |
| Total interest-bearing deposits     | 1,924                    | 2,163    | 2,703    | (239 )              | (540 )     |
| Borrowed funds:                     |                          |          |          |                     |            |
| Short-term                          | 32                       | 9        | 9        | 23                  | 0          |
| Long-term                           | 2,646                    | 2,950    | 3,053    | (304 )              | (103 )     |
| Total borrowed funds                | 2,678                    | 2,959    | 3,062    | (281 )              | (103 )     |
| Total Interest Expense              | 4,602                    | 5,122    | 5,765    | (520 )              | (643 )     |
| Net Interest Income                 | \$42,819                 | \$43,893 | \$46,384 | \$(1,074 )          | \$(2,491 ) |

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

(2) Fees on loans are included with interest on loans and amounted to \$1,004,000 in 2015, \$1,013,000 in 2014, and \$1,338,000 in 2013.

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

|   | Year<br>Ended<br>12/31/2015 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | Year<br>Ended<br>12/31/2014 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | Year<br>Ended<br>12/31/2013 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% |
|---|-----------------------------|---|-----------------------------|---|-----------------------------|---|
| <b>EARNING ASSETS</b>                             |                             |   |                             |   |                             |   |
| Available-for-sale securities, at amortized cost: |                             |   |                             |   |                             |   |
| Taxable   | \$366,448                   | 2.07 %  | \$371,125                   | 2.16 %  | \$330,980                   | 2.15 %  |
| Tax-exempt  | 112,700                     | 5.21 %  | 123,809                     | 5.31 %  | 130,584                     | 5.59 %  |
| Total available-for-sale securities               | 479,148                     | 2.81 %  | 494,934                     | 2.95 %  | 461,564                     | 3.12 %  |
| Interest-bearing due from banks                   | 22,201                      | 0.42 %  | 32,510                      | 0.38 %  | 26,159                      | 0.40 %  |
| Federal funds sold                                | 0                           | 0.00 %  | 0                           | 0.00 %  | 4                           | 0.00 %  |
| Loans held for sale                               | 222                         | 7.21 %  | 204                         | 7.84 %  | 1,118                       | 4.83 %  |
| Loans receivable:                                 |                             |   |                             |   |                             |   |
| Taxable   | 603,771                     | 5.19 %  | 589,120                     | 5.45 %  | 620,412                     | 5.72 %  |
| Tax-exempt  | 53,956                      | 4.72 %  | 38,633                      | 5.54 %  | 36,083                      | 5.83 %  |
| Total loans receivable                            | 657,727                     | 5.15 %  | 627,753                     | 5.46 %  | 656,495                     | 5.73 %  |
| Total Earning Assets                              | 1,159,298                   | 4.09 %  | 1,155,401                   | 4.24 %  | 1,145,340                   | 4.55 %  |
| Cash  | 16,639                      |   | 16,865                      |   | 16,854                      |   |
| Unrealized gain/loss on securities                | 8,871                       |   | 6,350                       |   | 8,875                       |   |
| Allowance for loan losses                         | (7,380 )                    |   | (7,992 )                    |   | (7,204 )                    |   |
| Bank premises and equipment                       | 15,911                      |   | 16,789                      |   | 18,154                      |   |
| Intangible Asset - Core Deposit Intangible        | 41                          |   | 70                          |   | 113                         |   |
| Intangible Asset – Goodwill                       | 11,942                      |   | 11,942                      |   | 11,942                      |   |
| Other assets                                      | 37,887                      |   | 40,472                      |   | 43,022                      |   |
| Total Assets                                      | \$1,243,209                 |   | \$1,239,897                 |   | \$1,237,096                 |   |
| <b>INTEREST-BEARING LIABILITIES</b>               |                             |   |                             |   |                             |   |
| Interest-bearing deposits:                        |                             |   |                             |   |                             |   |
| Interest checking                                 | \$195,940                   | 0.11 %  | \$183,874                   | 0.12 %  | \$174,790                   | 0.12 %  |
| Money market                                      | 196,585                     | 0.15 %  | 198,990                     | 0.14 %  | 203,023                     | 0.14 %  |
| Savings   | 128,355                     | 0.10 %  | 121,685                     | 0.10 %  | 117,055                     | 0.10 %  |
| Certificates of deposit                           | 121,803                     | 0.68 %  | 134,732                     | 0.79 %  | 148,598                     | 1.02 %  |
| Individual Retirement Accounts                    | 110,659                     | 0.41 %  | 120,016                     | 0.39 %  | 129,255                     | 0.43 %  |
| Other time deposits                               | 1,031                       | 0.10 %  | 1,039                       | 0.10 %  | 1,062                       | 0.09 %  |

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|   |             |        |             |        |             |        |
|---|-------------|--------|-------------|--------|-------------|--------|
| Total interest-bearing deposits                                 | 754,373     | 0.26 % | 760,336     | 0.28 % | 773,783     | 0.35 % |
| Borrowed funds:   |             |        |             |        |             |        |
| Short-term  | 11,428      | 0.28 % | 6,744       | 0.13 % | 6,422       | 0.14 % |
| Long-term   | 66,214      | 4.00 % | 73,196      | 4.03 % | 75,906      | 4.02 % |
| Total borrowed funds  | 77,642      | 3.45 % | 79,940      | 3.70 % | 82,328      | 3.72 % |
| Total Interest-bearing Liabilities                              | 832,015     | 0.55 % | 840,276     | 0.61 % | 856,111     | 0.67 % |
| Demand deposits   | 213,828     |        | 205,082     |        | 190,248     |        |
| Other liabilities   | 8,461       |        | 9,070       |        | 9,325       |        |
| Total Liabilities   | 1,054,304   |        | 1,054,428   |        | 1,055,684   |        |
| Stockholders' equity, excluding other comprehensive income/loss | 183,125     |        | 181,271     |        | 175,893     |        |
| Other comprehensive income/loss                                 | 5,780       |        | 4,198       |        | 5,519       |        |
| Total Stockholders' Equity                                      | 188,905     |        | 185,469     |        | 181,412     |        |
| Total Liabilities and Stockholders' Equity                      | \$1,243,209 |        | \$1,239,897 |        | \$1,237,096 |        |
| Interest Rate Spread  |             | 3.54 % |             | 3.63 % |             | 3.88 % |
| Net Interest Income/Earning Assets                              |             | 3.69 % |             | 3.80 % |             | 4.05 % |
| Total Deposits (Interest-bearing and Demand)                    | \$968,201   |        | \$965,418   |        | \$964,031   |        |

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

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



TABLE III - ANALYSIS OF VOLUME AND RATE CHANGES

| (In Thousands)                      | Year Ended 12/31/15 vs. 12/31/14 |                |              | Year Ended 12/31/14 vs. 12/31/13 |                |              |
|-------------------------------------|----------------------------------|----------------|--------------|----------------------------------|----------------|--------------|
|                                     | Change in Volume                 | Change in Rate | Total Change | Change in Volume                 | Change in Rate | Total Change |
| <b>EARNING ASSETS</b>               |                                  |                |              |                                  |                |              |
| Available-for-sale securities:      |                                  |                |              |                                  |                |              |
| Taxable                             | \$ (100 )                        | \$ (341 )      | \$ (441 )    | \$ 868                           | \$ 55          | \$ 923       |
| Tax-exempt                          | (581 )                           | (127 )         | (708 )       | (369 )                           | (350 )         | (719 )       |
| Total available-for-sale securities | (681 )                           | (468 )         | (1,149 )     | 499                              | (295 )         | 204          |
| Interest-bearing due from banks     | (42 )                            | 10             | (32 )        | 24                               | (4 )           | 20           |
| Loans held for sale                 | 1                                | (1 )           | 0            | (60 )                            | 22             | (38 )        |
| Loans receivable:                   |                                  |                |              |                                  |                |              |
| Taxable                             | 786                              | (1,602 )       | (816 )       | (1,746 )                         | (1,611 )       | (3,357 )     |
| Tax-exempt                          | 758                              | (355 )         | 403          | 144                              | (107 )         | 37           |
| Total loans receivable              | 1,544                            | (1,957 )       | (413 )       | (1,602 )                         | (1,718 )       | (3,320 )     |
| Total Interest Income               | 822                              | (2,416 )       | (1,594 )     | (1,139 )                         | (1,995 )       | (3,134 )     |
| <b>INTEREST-BEARING LIABILITIES</b> |                                  |                |              |                                  |                |              |
| Interest-bearing deposits:          |                                  |                |              |                                  |                |              |
| Interest checking                   | 14                               | (16 )          | (2 )         | 11                               | (6 )           | 5            |
| Money market                        | (3 )                             | 16             | 13           | (6 )                             | 2              | (4 )         |
| Savings                             | 7                                | 0              | 7            | 5                                | (1 )           | 4            |
| Certificates of deposit             | (97 )                            | (141 )         | (238 )       | (133 )                           | (320 )         | (453 )       |
| Individual Retirement Accounts      | (38 )                            | 19             | (19 )        | (38 )                            | (54 )          | (92 )        |
| Other time deposits                 | 0                                | 0              | 0            | 0                                | 0              | 0            |
| Total interest-bearing deposits     | (117 )                           | (122 )         | (239 )       | (161 )                           | (379 )         | (540 )       |
| Borrowed funds:                     |                                  |                |              |                                  |                |              |
| Short-term                          | 9                                | 14             | 23           | 0                                | 0              | 0            |
| Long-term                           | (279 )                           | (25 )          | (304 )       | (109 )                           | 6              | (103 )       |
| Total borrowed funds                | (270 )                           | (11 )          | (281 )       | (109 )                           | 6              | (103 )       |
| Total Interest Expense              | (387 )                           | (133 )         | (520 )       | (270 )                           | (373 )         | (643 )       |
| Net Interest Income                 | \$ 1,209                         | \$ (2,283 )    | \$ (1,074 )  | \$ (869 )                        | \$ (1,622 )    | \$ (2,491 )  |

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

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

**NONINTEREST INCOME****Years Ended December 31, 2015, 2014 and 2013**

The table below presents a comparison of noninterest income and excludes realized gains on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis.

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

|  | Years Ended          |          | \$        | %        |
|--|----------------------|----------|-----------|----------|
|  | December 31,<br>2015 | 2014     |           |          |
| Service charges on deposit accounts  | \$4,864              | \$5,025  | \$ (161 ) | (3.2 )   |
| Service charges and fees   | 494                  | 538      | (44 )     | (8.2 )   |
| Trust and financial management revenue   | 4,626                | 4,490    | 136       | 3.0      |
| Brokerage revenue  | 839                  | 901      | (62 )     | (6.9 )   |
| Insurance commissions, fees and premiums   | 109                  | 118      | (9 )      | (7.6 )   |
| Interchange revenue from debit card transactions   | 1,935                | 1,959    | (24 )     | (1.2 )   |
| Net gains from sales of loans  | 735                  | 768      | (33 )     | (4.3 )   |
| Decrease in fair value of servicing rights   | (162 )               | (27 )    | (135 )    | 500.0    |
| Increase in cash surrender value of life insurance                                       | 386                  | 376      | 10        | 2.7      |
| Net (loss) gain from premises and equipment  | (1 )                 | 8        | (9 )      | (112.5 ) |
| Other operating income   | 1,579                | 1,264    | 315       | 24.9     |
| Total other operating income before realized gains on available-for-sale securities, net | \$15,404             | \$15,420 | \$ (16 )  | (0.1 )   |

|   | Years Ended          |         | \$        | %        |
|---|----------------------|---------|-----------|----------|
|   | December 31,<br>2014 | 2013    |           |          |
| Service charges on deposit accounts                   | \$5,025              | \$5,246 | \$ (221 ) | (4.2 )   |
| Service charges and fees                              | 538                  | 597     | (59 )     | (9.9 )   |
| Trust and financial management revenue                | 4,490                | 4,087   | 403       | 9.9      |
| Brokerage revenue                                     | 901                  | 784     | 117       | 14.9     |
| Insurance commissions, fees and premiums              | 118                  | 170     | (52 )     | (30.6 )  |
| Interchange revenue from debit card transactions      | 1,959                | 1,941   | 18        | 0.9      |
| Net gains from sales of loans                         | 768                  | 1,969   | (1,201)   | (61.0 )  |
| (Decrease) increase in fair value of servicing rights | (27 )                | 67      | (94 )     | (140.3 ) |
| Increase in cash surrender value of life insurance    | 376                  | 399     | (23 )     | (5.8 )   |

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|  |          |          |           |         |
|--|----------|----------|-----------|---------|
| Net gain (loss) from premises and equipment  | 8        | (16 )    | 24        | (150.0) |
| Other operating income   | 1,264    | 1,207    | 57        | 4.7     |
| Total other operating income before realized gains on available-for-sale securities, net | \$15,420 | \$16,451 | \$(1,031) | (6.3 )  |

Total noninterest income, excluding realized gains on available-for-sale securities, decreased \$16,000 in 2015 compared to 2014. In 2014, total noninterest income decreased \$1,031,000 (6.3%) from 2013. Changes of significance are discussed in the narrative that follows.

**2015 vs. 2014**

Service charges on deposit accounts were \$161,000 lower in 2015 than 2014. Total consumer and business overdraft and uncollected funds fees decreased \$387,000 in 2015 as compared to 2014. These decreases were partially offset by adjustments to the existing fee structure of certain checking products in April 2015.

The fair value of servicing rights decreased \$162,000 in 2015 as compared to a decrease of \$27,000 in 2014. The greater decline in fair value in 2015 reflected the impact of a reduction in the outstanding balance of mortgage loans sold and serviced in 2015, as compared to an increase in the balance of loans serviced in 2014 over 2013.

Included in the \$315,000 increase in other operating revenue in 2015 is the effect of a \$212,000 gain recognized from a life insurance arrangement in which the benefits were split between Corporation and the heirs of the former employee.

In 2015, Trust and financial management revenue increased \$136,000, or 3.0%. This increase was primarily in retirement services revenue.

### **2014 vs. 2013**

Net gains from sales of loans decreased \$1,201,000 in 2014. Since December 2009, the Corporation has sold a significant amount of residential mortgage loans into the secondary market through the MPF Xtra and Original programs administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Volume remained brisk throughout most of 2013, slowing somewhat in the fourth quarter 2013 with a continued slowdown throughout 2014 reflecting a decrease in refinancing activity.

Service charges on deposit accounts were \$221,000 lower in 2014 than 2013. Consumer and business overdraft fees decreased \$543,000 in 2014 as compared to 2013. Changes made as a result of recommendations made by a consulting firm in 2013 resulted in service charges on deposit accounts of \$611,000 in 2014 as compared to \$229,000 in 2013, as most of the recommendations were implemented in the fourth quarter 2013.

In 2014, Trust and financial management revenue increased \$403,000, or 9.9%. The increase in trust revenue in 2014 reflects the impact of new business obtained as well as higher valuations of U.S. equity securities throughout most of the period. Assets under management by the Corporation's Trust and financial management group totaled \$825,918,000 at December 31, 2014, an increase of 3.7% over the total one year earlier.

As a result of increased annuity sales, brokerage revenue increased \$117,000 or 14.9% in 2014 over 2013.

### **NONINTEREST EXPENSE**

#### **Years Ended December 31, 2015, 2014 and 2013**

As shown in Table V below, total noninterest expense increased \$1,372,000, or 4.0%, in 2015 as compared to 2014; however, excluding losses from prepayment of debt, noninterest expense decreased \$1,201,000 (3.5%) in 2015 as compared to 2014. Excluding losses from prepayment of debt, total noninterest expense was \$686,000 (2.0%) higher in 2014 as compared to 2013. In 2015, the Corporation incurred losses totaling \$2,573,000 and, in 2013, losses totaling \$1,023,000 from prepayment of borrowings (repurchase agreements). There were no losses from prepayment of borrowings incurred in 2014. Changes of significance (other than the previously discussed losses on prepayment of debt) are discussed in the narrative that follows.

#### TABLE V - COMPARISON OF NONINTEREST EXPENSE

(In Thousands)

|  | 2015     | 2014     | \$       | %       |
|--|----------|----------|----------|---------|
|  |          |          | Change   | Change  |
| Salaries and wages                               | \$14,682 | \$15,121 | \$(439 ) | (2.9 )  |
| Pensions and other employee benefits             | 4,420    | 4,769    | (349 )   | (7.3 )  |
| Occupancy expense, net                           | 2,574    | 2,628    | (54 )    | (2.1 )  |
| Furniture and equipment expense                  | 1,860    | 1,859    | 1        | 0.1     |
| FDIC Assessments                                 | 603      | 600      | 3        | 0.5     |
| Pennsylvania shares tax                          | 1,174    | 1,350    | (176 )   | (13.0 ) |
| Professional fees                                | 538      | 699      | (161 )   | (23.0 ) |
| Automated teller machine and interchange expense | 988      | 924      | 64       | 6.9     |
| Software subscriptions                           | 876      | 784      | 92       | 11.7    |
| Loss on prepayment of debt                       | 2,573    | 0        | 2,573    | 100.0   |
| Other operating expense                          | 5,241    | 5,423    | (182 )   | (3.4 )  |
| Total Other Expense                              | \$35,529 | \$34,157 | \$1,372  | 4.0     |

|  | 2014     | 2013     | \$<br>Change | %<br>Change |
|--|----------|----------|--------------|-------------|
| Salaries and wages                               | \$15,121 | \$14,206 | \$915        | 6.4         |
| Pensions and other employee benefits             | 4,769    | 4,150    | 619          | 14.9        |
| Occupancy expense, net                           | 2,628    | 2,473    | 155          | 6.3         |
| Furniture and equipment expense                  | 1,859    | 1,948    | (89 )        | (4.6 )      |
| FDIC Assessments                                 | 600      | 604      | (4 )         | (0.7 )      |
| Pennsylvania shares tax                          | 1,350    | 1,402    | (52 )        | (3.7 )      |
| Professional fees                                | 699      | 1,534    | (835 )       | (54.4 )     |
| Automated teller machine and interchange expense | 924      | 1,020    | (96 )        | (9.4 )      |
| Software subscriptions                           | 784      | 836      | (52 )        | (6.2 )      |
| Loss on prepayment of debt                       | 0        | 1,023    | (1,023 )     | (100.0 )    |
| Other operating expense                          | 5,423    | 5,298    | 125          | 2.4         |
| Total Other Expense                              | \$34,157 | \$34,494 | \$(337 )     | (1.0 )      |

#### 2015 vs 2014

Salaries and wages decreased \$439,000, or 2.9%. As noted in the Earnings Overview section, this decrease is primarily the result of severance benefits incurred and paid in 2014. The decrease from severance benefits was partially offset by annual merit-based pay increases, an increase in incentive and other bonuses of \$168,000 and the addition of new lending and other personnel. At December 31, 2015, the Corporation had 283 full-time equivalent employees, up from 278 a year earlier.

Pensions and other employee benefits decreased \$349,000, or 7.3%. Health care expense decreased \$342,000 as the amount of claims incurred during 2015 was lower than in 2014. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party. In addition, pension expense decreased \$111,000 as the result of a charge in 2014 related to a distribution from a defined benefit plan. These decreases were partially offset by annual increases in other benefit and administrative costs.

Pennsylvania shares tax decreased \$176,000, including the effects of increased participation in state tax credit programs.

Professional fees decreased \$161,000 as a result of nonrecurring executive search expenses that were incurred in 2014.

Included in other operating expense is a \$191,000 decrease in loan collection expenses as well as an \$86,000 decrease in other real estate expenses.

**2014 vs. 2013**

Salaries and wages increased \$915,000, or 6.4%. As noted in the Earnings Overview section, this increase is primarily the result of severance benefits incurred and paid in 2014.

Pensions and other employee benefits increased \$619,000, or 14.9%. Health care expense increased \$415,000 as the amount of claims incurred during 2014 was higher than in 2013. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party. In addition, the Corporation incurred a \$196,000 charge related to a distribution from a defined benefit plan.

Occupancy expense increased \$155,000, or 6.3%, primarily due to increased weather related costs such as snow removal, fuel, utilities and maintenance.

Professional fees decreased \$835,000, or 54.4%. The Corporation incurred professional fee expense of \$1,039,000 in 2013 for two large consulting engagements. Similar size engagements did not occur during 2014.

Automated teller machine and interchange expenses decreased \$96,000, or 9.4%, mainly resulting from benefits derived from a consulting project related to electronic funds processing that took place in 2013.

## INCOME TAXES

The effective income tax rate was approximately 24.5% of pre-tax income in 2015, and 25% of pre-tax income in 2014 and 2013. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At December 31, 2015, the net deferred tax asset was \$3,115,000, an increase from the balance at December 31, 2014 of \$1,668,000. The largest changes in temporary difference components were as follows:

Primarily as a result of the realization of \$2,861,000 in gains on the sale of available-for-sale securities, the deferred tax liability resulting from net unrealized gains on available-for-sale securities decreased to \$1,342,000 at December 31, 2015 from \$2,844,000 at December 31, 2014.

There was no deferred tax asset representing a credit for alternative minimum tax paid at December 31, 2015 as the Corporation's federal taxable income in 2015 exceeded alternative minimum taxable income sufficiently to utilize the available credit. At December 31, 2014 the related deferred tax asset amounted to \$537,000.

The Corporation regularly reviews deferred tax assets for recoverability based on history of earnings, expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. Management believes the recorded net deferred tax asset at December 31, 2015 is fully realizable; however, if management determines the Corporation will be unable to realize all or part of the net deferred tax asset, the Corporation would adjust the deferred tax asset, which would negatively impact earnings.

Additional information related to income taxes is presented in Note 14 to the consolidated financial statements.

## SECURITIES

Table VI shows the composition of the investment portfolio at December 31, 2015, 2014 and 2013. Comparison of the amortized cost totals of available-for-sale securities at each year-end presented reflects an increase of \$24,479,000 to \$508,682,000 at December 31, 2014 from December 31, 2013. This change was followed by a decrease of



\$92,227,000 to \$416,455,000 at December 31, 2015. After experiencing an increase in securities in 2014 as a result of a reduction in the balances of loans outstanding, the Corporation saw a reversal of that trend in 2015. The decrease in securities in 2015 reflects, in part, using cash generated from the investment portfolio to fund the increase in loans outstanding. Over the last year, the Corporation saw a decrease in almost all categories of investments, with the largest decrease being a \$46,475,000 reduction in collateralized mortgage-backed obligations (CMOs) issued or guaranteed by U.S. Government agencies. As discussed in more detail in Note 7 to the financial statements, the Corporation reported net realized gains from available-for-sale securities of \$2,861,000 in 2015, including realized gains from sales of equity securities (bank stocks) of \$2,220,000. In comparison, net realized gains from available-for-sale securities totaled \$1,104,000 in 2014 and \$1,718,000 in 2013.

As reflected in Table VI, the fair value of available-for-sale securities as of December 31, 2015 was \$3,835,000, or 0.92%, higher than the total amortized cost basis. The aggregate unrealized gain position at December 31, 2015 was down from \$8,125,000 at December 31, 2014, mainly due to sales of a significant portion of the Corporation's equity securities with substantial market appreciation in 2015. The aggregate unrealized gain position at December 31, 2015 included an unrealized gain of \$3,129,000 on debt securities as well as an unrealized gain of \$706,000 on marketable equity securities. Changes in intermediate-term and long-term interest rates have a significant impact on changes in fair values of debt securities. The aggregate unrealized gain on debt securities at December 31, 2015 was 0.75% of the amortized cost basis, down slightly from 1.01% at December 31, 2014 and up from a net unrealized loss on debt securities of 0.93% of amortized cost at December 31, 2013.

Management has reviewed the Corporation's holdings as of December 31, 2015 and concluded that unrealized losses on all of the securities in an unrealized loss position are considered temporary. Notes 6 and 7 to the consolidated financial statements provide more detail concerning the Corporation's processes for evaluating securities for other-than-temporary impairment. Management will continue to closely monitor the status of impaired securities in 2016.

TABLE VI - INVESTMENT SECURITIES

| (In Thousands)  | 2015           |            | As of December 31,<br>2014 |            | 2013           |            |
|---|----------------|------------|----------------------------|------------|----------------|------------|
|   | Amortized Cost | Fair Value | Amortized Cost             | Fair Value | Amortized Cost | Fair Value |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>                                   |                |            |                            |            |                |            |
| Obligations of U.S. Government agencies                                 | \$10,663       | \$10,483   | \$27,221                   | \$26,676   | \$47,382       | \$45,877   |
| Obligations of states and political subdivisions:                       |                |            |                            |            |                |            |
| Tax-exempt  | 103,414        | 107,757    | 120,086                    | 124,839    | 127,748        | 128,426    |
| Taxable   | 34,317         | 34,597     | 33,637                     | 33,878     | 35,154         | 34,471     |
| Mortgage-backed securities  | 73,227         | 73,343     | 82,479                     | 83,903     | 84,849         | 86,208     |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 193,145        | 191,715    | 239,620                    | 238,823    | 182,372        | 178,092    |
| Other collateralized debt obligations                                   | 9              | 9          | 34                         | 34         | 660            | 660        |
| Total debt securities   | 414,775        | 417,904    | 503,077                    | 508,153    | 478,165        | 473,734    |
| Marketable equity securities  | 1,680          | 2,386      | 5,605                      | 8,654      | 6,038          | 8,924      |
| Total   | \$416,455      | \$420,290  | \$508,682                  | \$516,807  | \$484,203      | \$482,658  |

The following table presents the contractual maturities and the weighted-average yields (calculated based on amortized cost) of investment securities as of December 31, 2015. Yields on tax-exempt securities are presented on a nominal basis, that is, the yields are not presented on a fully taxable-equivalent basis. 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, Except for Percentages)            | Within One Year |       | One-Five Years |       | Five-Ten Years |       | After Ten Years |       | Total     | Yield |
|---|-----------------|-------|----------------|-------|----------------|-------|-----------------|-------|-----------|-------|
|   | Year            | Yield | Years          | Yield | Years          | Yield | Years           | Yield |           |       |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>             |                 |       |                |       |                |       |                 |       |           |       |
| Obligations of U.S. Government agencies           | \$1,006         | 3.32% | \$6,650        | 1.35% | \$3,007        | 1.53% | \$0             | 0.00% | \$10,663  | 1.59% |
| Obligations of states and political subdivisions: |                 |       |                |       |                |       |                 |       |           |       |
| Tax-exempt  | 4,645           | 2.83% | 36,609         | 2.48% | 28,666         | 2.70% | 33,494          | 4.74% | 103,414   | 3.29% |
| Taxable   | 3,436           | 2.03% | 17,381         | 2.02% | 13,500         | 2.91% | 0               | 0.00% | 34,317    | 2.37% |
| Other collateralized debt obligations             | 0               | 0.00% | 0              | 0.00% | 0              | 0.00% | 9               | 0.00% | 9         | 0.00% |
| Subtotal  | \$9,087         | 2.58% | \$60,640       | 2.23% | \$45,173       | 2.69% | \$33,503        | 4.73% | \$148,403 | 2.95% |
| Mortgage-backed securities                        |                 |       |                |       |                |       |                 |       | 73,227    | 2.17% |
|   |                 |       |                |       |                |       |                 |       | 193,145   | 2.01% |

Collateralized mortgage  
obligations, Issued by U.S.  
Government agencies  
Total

\$414,775 2.38%

The Corporation's mortgage-backed securities and collateralized mortgage obligations have stated maturities that may differ from actual maturities due to borrowers' ability to prepay obligations. Cash flows from such investments are dependent upon the performance of the underlying mortgage loans and are generally influenced by the level of interest rates. As rates increase, cash flows generally decrease as prepayments on the underlying mortgage loans decrease. As rates decrease, cash flows generally increase as prepayments increase due to increased refinance activity and other factors. In the table above, the entire balances and weighted-average rates for mortgage-backed securities and collateralized mortgage obligations are shown in one period.

## FINANCIAL CONDITION

Gross loans outstanding (excluding mortgage loans held for sale) were \$704,880,000 at December 31, 2015, up 11.8% from \$630,545,000 at December 31, 2014. The outstanding balance of tax-exempt municipal loans totaled \$40,007,000 at December 31, 2015, an increase of \$22,473,000 from December 31, 2014, and total participation loans outstanding amounted to \$33,059,000 at December 31, 2015, an increase of \$28,113,000 from December 31, 2014. The increase in municipal loans in 2015 includes loans to two school districts in the Corporation's market area with outstanding balances totaling \$15,947,000 at December 31, 2015. Participation loans represent portions of larger commercial transactions for which other institutions are the "lead banks". Although not the lead bank, the Corporation conducts detailed underwriting and monitoring of participation loan opportunities. Participation loans are included in the "Commercial and industrial" and "Commercial loans secured by real estate" classes in the loan tables presented in this Form 10-K. At December 31, 2015, the balance of participation loans outstanding includes \$8,860,000 to a business based in the Corporation's market area, \$10,000,000 to an entity located outside of the Corporation's market area and \$10,020,000 from participations in loans originated through the Corporation's membership in a network that originates loans throughout the U.S. The Corporation's participation loans originated through the network consist of loans to businesses that are larger than the Corporation's typical commercial customer base. The loans originated through the network are considered "leveraged loans," meaning the businesses typically have minimal tangible book equity and the extent of collateral available is limited, though the businesses have demonstrated strong cash flow performance in their recent histories.

The balance of available-for-sale securities fell \$96,517,000 to \$420,290,000 at December 31, 2015 from \$516,807,000 at December 31, 2014. As discussed in the Earnings Overview section, the reduction included sales of securities for which the proceeds were used to pre-pay long-term debt with a book value of \$34 million prior to the pay-down. The reduction also included use of proceeds from calls and maturities of securities to fund the increase in loans receivable and to offset some of the impact of the decrease in deposits in the second half of 2015, as the Pennsylvania state budget impasse led to reduced deposit balances held by municipal entities such as school districts, local governments and human service agencies.

Other significant changes in the average balances of the Corporation's earning assets and interest-bearing liabilities are described in the Net Interest Income section of Management's Discussion and Analysis. The discussion provides useful information regarding changes in the Corporation's balance sheet over the 3-year period ended December 31, 2015, including discussions related to available-for-sale securities, loans, deposits and borrowings. Other significant balance sheet items - the allowance for loan losses and stockholders' equity - are discussed in separate sections of Management's Discussion and Analysis.

Table VIII presents loan maturity data as of December 31, 2015. The interest rate simulation model classifies certain loans under different categories than they appear in Table VII. Fixed-rate loans are shown in Table VIII based on their contractually scheduled principal repayments, and variable-rate loans are shown based on the date of the next change in rate. Table VIII shows that fixed-rate loans are approximately 39% of the loan portfolio. Of the 61% of the

portfolio made up of variable-rate loans, a significant portion (42%) will re-price after more than one year. Variable-rate loans re-pricing after more than one year include significant amounts of residential and commercial real estate loans. The Corporation's substantial investment in long-term, fixed-rate loans and variable-rate loans with extended periods until re-pricing is one of the concerns management attempts to address through interest rate risk management practices. See Part II, Item 7A for a more detailed discussion of the Corporation's interest rate risk.

Since 2009, the Corporation has originated and sold residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Residential mortgages originated and sold through the MPF Xtra program consist primarily of conforming, prime loans sold to the Federal National Mortgage Association (Fannie Mae), a government agency. In 2014, the Corporation began to originate and sell residential mortgage loans to the secondary market through the MPF Original program, which is also administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Residential mortgages originated and sold through the MPF Original program consist primarily of conforming, prime loans sold to the Federal Home Loan Bank of Pittsburgh. For loans sold under the Original program, the Corporation provides a credit enhancement whereby the Corporation would assume credit losses in excess of a defined First Loss Account ("FLA") balance, up to specified amounts. The FLA is funded by the Federal Home Loan Bank of Pittsburgh based on a percentage of the outstanding balance of loans sold. The Corporation does not provide a credit enhancement for loans sold through the Xtra program.

For loan sales originated under the MPF Xtra and Original programs, the Corporation provides customary representations and warranties to investors that specify, among other things, that the loans have been underwritten to the standards established by the investor. The Corporation may be required to repurchase a loan and reimburse a portion of fees received, or reimburse the investor for a credit loss incurred on a loan, if it is determined that the representations and warranties have not been met. Such repurchases or reimbursements generally result from an underwriting or documentation deficiency. At December 31, 2015, the total outstanding balance of loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to \$1,968,000, and the corresponding total outstanding balance repurchased at December 31, 2014 was \$1,802,000.

At December 31, 2015, outstanding balances of loans sold and serviced through the two programs totaled \$152,448,000, including loans sold through the MPF Xtra program of \$125,571,000 and loans sold through the Original program of \$26,877,000. At December 31, 2014, outstanding balances of loans sold and serviced through the two programs totaled \$152,505,000, including loans sold through the MPF Xtra program of \$144,743,000 and loans sold through the Original program of \$7,762,000. Based on the fairly limited volume of required repurchases to date, and of sales through the Original program with credit enhancement, no allowance had been established for representation and warranty exposures, or for credit losses on loan sales through the Original program as of December 31, 2015 and 2014.

Total future capital purchases in 2016 are estimated at approximately \$2.8 million. Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition during 2016.

**TABLE VII - Five-year Summary of Loans by Type**

(In Thousands)

|   | 2015      | %    | 2014      | %    | 2013      | %    | 2012      | %    | 2011      | %    |
|---|-----------|------|-----------|------|-----------|------|-----------|------|-----------|------|
| Residential mortgage:                     |           |      |           |      |           |      |           |      |           |      |
| Residential mortgage loans - first liens  | \$304,783 | 43.2 | \$291,882 | 46.3 | \$299,831 | 46.5 | \$311,627 | 45.6 | \$331,015 | 46.7 |
| Residential mortgage loans - junior liens | 21,146    | 3.0  | 21,166    | 3.4  | 23,040    | 3.6  | 26,748    | 3.9  | 28,851    | 4.1  |
| Home equity lines of credit               | 39,040    | 5.5  | 36,629    | 5.8  | 34,530    | 5.4  | 33,017    | 4.8  | 30,037    | 4.2  |
| 1-4 Family residential construction       | 21,121    | 3.0  | 16,739    | 2.7  | 13,909    | 2.2  | 12,842    | 1.9  | 9,959     | 1.4  |
| Total residential mortgage                | 386,090   | 54.8 | 366,416   | 58.1 | 371,310   | 57.6 | 384,234   | 56.2 | 399,862   | 56.5 |
| Commercial:                               |           |      |           |      |           |      |           |      |           |      |
| Commercial loans secured by real estate   | 154,779   | 22.0 | 145,878   | 23.1 | 147,215   | 22.8 | 158,413   | 23.2 | 156,388   | 22.1 |
| Commercial and industrial                 | 75,196    | 10.7 | 50,157    | 8.0  | 42,387    | 6.6  | 48,442    | 7.1  | 57,191    | 8.1  |
| Political subdivisions                    | 40,007    | 5.7  | 17,534    | 2.8  | 16,291    | 2.5  | 31,789    | 4.6  | 37,620    | 5.3  |
|   | 5,122     | 0.7  | 6,938     | 1.1  | 17,003    | 2.6  | 28,200    | 4.1  | 23,518    | 3.3  |

|                                      |           |       |           |       |           |       |           |       |           |       |
|--------------------------------------|-----------|-------|-----------|-------|-----------|-------|-----------|-------|-----------|-------|
| Commercial construction              |           |       |           |       |           |       |           |       |           |       |
| Loans secured by farmland            | 7,019     | 1.0   | 7,916     | 1.3   | 10,468    | 1.6   | 11,403    | 1.7   | 10,949    | 1.5   |
| Multi-family (5 or more) residential | 9,188     | 1.3   | 8,917     | 1.4   | 10,985    | 1.7   | 6,745     | 1.0   | 6,583     | 0.9   |
| Agricultural loans                   | 4,671     | 0.7   | 3,221     | 0.5   | 3,251     | 0.5   | 3,053     | 0.4   | 2,987     | 0.4   |
| Other commercial loans               | 12,152    | 1.7   | 13,334    | 2.1   | 14,631    | 2.3   | 362       | 0.1   | 552       | 0.1   |
| Total commercial                     | 308,134   | 43.7  | 253,895   | 40.3  | 262,231   | 40.7  | 288,407   | 42.2  | 295,788   | 41.8  |
| Consumer                             | 10,656    | 1.5   | 10,234    | 1.6   | 10,762    | 1.7   | 11,269    | 1.6   | 12,665    | 1.8   |
| Total                                | 704,880   | 100.0 | 630,545   | 100.0 | 644,303   | 100.0 | 683,910   | 100.0 | 708,315   | 100.0 |
| Less: allowance for loan losses      | (7,889 )  |       | (7,336 )  |       | (8,663 )  |       | (6,857 )  |       | (7,705 )  |       |
| Loans, net                           | \$696,991 |       | \$623,209 |       | \$635,640 |       | \$677,053 |       | \$700,610 |       |

**TABLE VIII – LOAN MATURITY DISTRIBUTION****(In Thousands)**

As of December 31, 2015

|             | Fixed-Rate Loans |           |           |           | Variable- or Adjustable-Rate Loans |           |          |           |
|-------------|------------------|-----------|-----------|-----------|------------------------------------|-----------|----------|-----------|
|             | 1 Year or Less   | 1-5 Years | >5 Years  | Total     | 1 Year or Less                     | 1-5 Years | >5 Years | Total     |
| Real Estate | \$2,915          | \$17,658  | \$171,617 | \$192,190 | \$87,874                           | \$183,361 | \$78,665 | \$349,900 |
| Commercial  | 8,964            | 28,121    | 31,850    | 68,935    | 51,460                             | 31,220    | 602      | 83,282    |
| Consumer    | 1,899            | 5,257     | 3,340     | 10,496    | 41                                 | 0         | 36       | 77        |
| Total       | \$13,778         | \$51,036  | \$206,807 | \$271,621 | \$139,375                          | \$214,581 | \$79,303 | \$433,259 |

**PROVISION AND ALLOWANCE FOR LOAN LOSSES**

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. Notes 1 and 8 to the consolidated financial statements provide an overview of the process management uses for evaluating and determining the allowance for loan losses.

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





The allowance for loan losses was \$7,889,000 at December 31, 2015, up from \$7,336,000 at December 31, 2014. As shown in Table X, specific allowances on impaired loans totaled \$820,000 at December 31, 2015, which was \$51,000 higher than the total of specific allowances on impaired loans at December 31, 2014. Table X also shows the collectively determined component of the allowance for commercial loans was \$371,000 higher and for residential mortgages was \$122,000 higher at December 31, 2015 than at December 31, 2014. The increase in loans outstanding had the effect of increasing the collectively determined portion of the allowance for loan losses, as the Corporation's net charge-off experience and qualitative data used in the December 31, 2015 allowance calculations were comparable to the December 31, 2014 data.

The provision for loan losses is determined based on the amount required in order to maintain an appropriate allowance for loan losses in light of all factors considered. The provision for loan losses by segment for 2015, 2014 and 2013 is as follows:

(In Thousands)

|                      | 2015    | 2014  | 2013    |
|----------------------|---------|-------|---------|
| Residential mortgage | \$(19 ) | \$250 | \$559   |
| Commercial           | 816     | 227   | 1,507   |
| Consumer             | 16      | 2     | 24      |
| Unallocated          | 32      | (3 )  | (43 )   |
| Total                | \$845   | \$476 | \$2,047 |

The provision for loan losses was \$845,000 in 2015, in comparison to \$476,000 in 2014 and \$2,047,000 in 2013. As shown in Table XII, the average provision for loan losses for the five-year period ended December 31, 2015 was \$674,000. The total amount of the provision for loan losses for each period is determined based on the amount required to maintain an appropriate allowance.

In 2015, the provision for loan losses related to the commercial segment was \$816,000, as compared to \$227,000 in 2014 and \$1,507,000 in 2013. The increase in the provision for the commercial segment in 2015 as compared to 2014 includes the effects of the increase in the collectively determined allowance due to loan growth, as previously described. The provision for the commercial segment in 2015 also reflects the establishment of an allowance of \$595,000 on a multi-family residential loan with a balance of \$987,000 at December 31, 2015, partially offset by the effects of a recovery of \$208,000 on loans charged-off in prior years. In 2014, the provision for the commercial segment included the effects of increases as compared to 2013 in average net charge-offs (based on historical experience over the previous thirty-six months) and qualitative factors used to estimate a portion of the collectively determined allowance, partially offset by lower loan balances, while the 2013 provision related to the commercial segment included a provision of \$1,552,000 from the establishment of an allowance on loans to one borrower.

In 2015, the \$19,000 credit for loan losses in the residential mortgage segment relates primarily to an adjustment to a specific allowance related to one loan relationship, partially offset by the effects of the previously described increase in the collectively determined allowance due to loan growth. In 2014, the provision for the residential mortgage segment was \$250,000 as compared to \$559,000 in 2013, reflecting the effect of lower loans outstanding.

Table XI presents information related to past due and impaired loans, and loans that have been modified under terms that are considered troubled debt restructurings (TDRs). Table XI shows total impaired loans of \$9,774,000 at December 31, 2015, down \$2,342,000 from the corresponding amount at December 31, 2014 of \$12,316,000. Table XI shows that total impaired loans at December 31, 2013 was significantly higher than the corresponding amounts at December 31, 2011 and 2012, and that the amount of impaired loans (as well as nonperforming loans as reflected in the table) decreased in 2014 and again in 2015. The increase in impaired and nonaccrual loans outstanding in 2013, and the subsequent decrease in 2014 and 2015, included the effects of changes in the outstanding balance of large loans to two commercial entities. For one of the credits for which there was a loan balance of \$1,815,000 and an allowance of \$211,000 at December 31, 2014 and \$72,000 at December 31, 2013, the Corporation acquired the commercial property that had collateralized the loan through foreclosure and sold the property, resulting in no remaining loan balance and a charge-off of \$115,000 in 2015. For the other large commercial relationship, as described in the following paragraph, during the second quarter 2014, the Corporation recorded a charge-off of \$1,486,000 related to a restructuring, which has reduced the outstanding balance of loans to this commercial entity to \$4,997,000 at December 31, 2015.

As shown in Table XI, loans classified as TDRs decreased to \$6,364,000 at December 31, 2015 from \$7,195,000 at December 31, 2014. The reduction in outstanding TDRs in 2015 includes the effect of pay-offs received on loans secured by farmland. The balance of TDRs at December 31, 2014 had increased from \$4,175,000 at December 31, 2013, mainly due to a restructuring agreement with one commercial borrower. The Corporation entered into a forbearance agreement with this commercial borrower which includes a reduction in monthly payment amounts over a fifteen-month period. At the end of the fifteen-month period, the monthly payment amounts would revert to the original amounts, unless the forbearance agreement is extended or the payment requirements are otherwise modified. In July 2015, the forbearance agreement was extended for twelve months. The Corporation recorded a charge-off of \$1,486,000 in the second quarter 2014 as a result of these modifications, as the payment amounts based on the forbearance agreement are not sufficient to fully amortize the contractual amount of principal outstanding on the loans. The amount of the charge-off was determined based on the excess of the contractual principal due over the present value of the payment amounts provided for in the forbearance agreement, assuming the revised payment amounts would continue until maturity, at the contractual interest rates.

Table XI reflects total loans past due 30-89 days and still accruing interest at December 31, 2015 of \$7,057,000, down slightly from the December 31, 2014 total of \$7,121,000. Total loans past due 90 days or more and still in accrual status increased to \$3,229,000 at December 31, 2015 from \$2,843,000 at December 31, 2014 mainly due to increased past due 1-4 family residential mortgages. Interest continues to be accrued on loans 90 days or more past due that management deems to be well secured and in the process of collection, and for which no loss is anticipated. Over the period 2011-2015, each period includes a few large commercial relationships that have required significant monitoring and workout efforts. As a result, a limited number of relationships may significantly impact the total amount of allowance required on impaired loans, and may significantly impact the amount of total charge-offs reported in any one period.

Management believes it has been conservative in its decisions concerning identification of impaired loans, estimates of loss, and nonaccrual status; however, the actual losses realized from these relationships could vary materially from the allowances calculated as of December 31, 2015. Management continues to closely monitor its commercial loan relationships for possible credit losses, and will adjust its estimates of loss and decisions concerning nonaccrual status, if appropriate.

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

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

| (In Thousands)             | Years Ended December 31, |         |         |         |         |
|----------------------------|--------------------------|---------|---------|---------|---------|
|                            | 2015                     | 2014    | 2013    | 2012    | 2011    |
| Balance, beginning of year | \$7,336                  | \$8,663 | \$6,857 | \$7,705 | \$9,107 |

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|   |         |         |         |         |         |
|---|---------|---------|---------|---------|---------|
| Charge-offs:                            |         |         |         |         |         |
| Residential mortgage                    | (217 )  | (327 )  | (95 )   | (552 )  | (100 )  |
| Commercial                              | (251 )  | (1,715) | (459 )  | (498 )  | (1,189) |
| Consumer                                | (94 )   | (97 )   | (117 )  | (171 )  | (157 )  |
| Total charge-offs                       | (562 )  | (2,139) | (671 )  | (1,221) | (1,446) |
| Recoveries:                             |         |         |         |         |         |
| Residential mortgage                    | 1       | 25      | 24      | 18      | 3       |
| Commercial                              | 214     | 264     | 348     | 8       | 255     |
| Consumer                                | 55      | 47      | 58      | 59      | 71      |
| Total recoveries                        | 270     | 336     | 430     | 85      | 329     |
| Net charge-offs                         | (292 )  | (1,803) | (241 )  | (1,136) | (1,117) |
| Provision (credit) for loan losses      | 845     | 476     | 2,047   | 288     | (285 )  |
| Balance, end of period                  | \$7,889 | \$7,336 | \$8,663 | \$6,857 | \$7,705 |
| Net charge-offs as a % of average loans | 0.04 %  | 0.29 %  | 0.04 %  | 0.16 %  | 0.16 %  |

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

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

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

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



**TABLE XII - FIVE-YEAR HISTORY OF LOAN LOSSES****(In Thousands)**

|  | 2015      | 2014      | 2013      | 2012      | 2011      | Average   |
|--|-----------|-----------|-----------|-----------|-----------|-----------|
| Average gross loans  | \$657,727 | \$627,753 | \$656,495 | \$700,241 | \$714,421 | \$671,327 |
| Year-end gross loans   | 704,880   | 630,545   | 644,303   | 683,910   | 708,315   | 674,391   |
| Year-end allowance for loan losses                           | 7,889     | 7,336     | 8,663     | 6,857     | 7,705     | 7,690     |
| Year-end nonaccrual loans                                    | 11,517    | 12,610    | 14,934    | 7,353     | 7,197     | 10,722    |
| Year-end loans 90 days or more past due and still accruing   | 3,229     | 2,843     | 3,131     | 2,311     | 1,267     | 2,556     |
| Net charge-offs  | 292       | 1,803     | 241       | 1,136     | 1,117     | 918       |
| Provision (credit) for loan losses                           | 845       | 476       | 2,047     | 288       | (285)     | 674       |
| Earnings coverage of charge-offs                             | 56        | 9         | 77        | 20        | 21        | 21        |
| Allowance coverage of charge-offs                            | 27        | 4         | 36        | 6         | 7         | 8         |
| Net charge-offs as a % of provision (credit) for loan losses | 34.56 %   | 378.78 %  | 11.77 %   | 394.44 %  | -391.93 % | 136.20 %  |
| Net charge-offs as a % of average gross loans                | 0.04 %    | 0.29 %    | 0.04 %    | 0.16 %    | 0.16 %    | 0.14 %    |
| Net income   | 16,471    | 17,086    | 18,594    | 22,705    | 23,368    | 19,645    |

**CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS**

Table XIII presents the Corporation's significant fixed and determinable contractual obligations as of December 31, 2015 by payment date. The payment amounts represent the principal amounts of time deposits and borrowings and do not include interest.

**TABLE XIII – CONTRACTUAL OBLIGATIONS****(In Thousands)**

|                                      | 1 Year<br>or Less | 1-3<br>Years | 3-5<br>Years | Over 5<br>Years | Total     |
|--------------------------------------|-------------------|--------------|--------------|-----------------|-----------|
| Time deposits                        | \$124,562         | \$73,596     | \$23,515     | \$11            | \$221,684 |
| Short-term borrowings:               |                   |              |              |                 |           |
| Federal Home Loan Bank of Pittsburgh | 48,581            | 0            | 0            | 0               | 48,581    |
| Customer repurchase agreements       | 4,915             | 0            | 0            | 0               | 4,915     |
| Long-term borrowings:                |                   |              |              |                 |           |
| Federal Home Loan Bank of Pittsburgh | 57                | 10,010       | 0            | 1,700           | 11,767    |
| Repurchase agreements                | 0                 | 27,000       | 0            | 0               | 27,000    |

|       |           |           |          |         |           |
|-------|-----------|-----------|----------|---------|-----------|
| Total | \$178,115 | \$110,606 | \$23,515 | \$1,711 | \$313,947 |
|-------|-----------|-----------|----------|---------|-----------|

In addition to the amounts described in Table XIII, the Corporation has obligations related to deposits without a stated maturity with outstanding principal balances totaling \$713,931,000 at December 31, 2015.

The Corporation's operating lease and other commitments at December 31, 2015 are immaterial. The Corporation's significant off-balance sheet arrangements consist of commitments to extend credit and standby letters of credit. Off-balance sheet arrangements are described in Note 16 to the consolidated financial statements.

## **LIQUIDITY**

Liquidity is the ability to quickly raise cash at a reasonable cost. An adequate liquidity position permits the Corporation to pay creditors, compensate for unforeseen deposit fluctuations and fund unexpected loan demand. At December 31, 2015, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$18,603,000.

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



The Corporation has a line of credit with the Federal Reserve Bank of Philadelphia's Discount Window. Management intends to use this line of credit as a contingency funding source. As collateral for the line, the Corporation has pledged available-for-sale securities with a carrying value of \$20,039,000 at December 31, 2015.

The Corporation's outstanding, available, and total credit facilities at December 31, 2015 and December 31, 2014 are as follows:

| (In Thousands)                       | Outstanding   |               | Available     |               | Total Credit  |               |
|--------------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
|                                      | Dec. 31, 2015 | Dec. 31, 2014 | Dec. 31, 2015 | Dec. 31, 2014 | Dec. 31, 2015 | Dec. 31, 2014 |
| Federal Home Loan Bank of Pittsburgh | \$60,348      | \$12,060      | \$262,361     | \$311,007     | \$322,709     | \$323,067     |
| Federal Reserve Bank Discount Window | 0             | 0             | 19,606        | 25,367        | 19,606        | 25,367        |
| Other correspondent banks            | 0             | 0             | 45,000        | 45,000        | 45,000        | 45,000        |
| Total credit facilities              | \$60,348      | \$12,060      | \$326,967     | \$381,374     | \$387,315     | \$393,434     |

At December 31, 2015, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of overnight borrowings of \$23,500,000, short-term borrowings of \$25,081,000, and long-term borrowings with a total amount of \$11,767,000. At December 31, 2014, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of long-term borrowings with a total amount of \$12,060,000. Additional information regarding borrowed funds is included in Note 12 to the consolidated financial statements.

Additionally, the Corporation uses repurchase agreements placed with brokers to borrow funds secured by investment assets and "RepoSweep" arrangements to borrow funds from commercial banking customers on an overnight basis. If required to raise cash in an emergency situation, the Corporation could sell available-for-sale securities to meet its obligations. At December 31, 2015, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was \$255,527,000.

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

## STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY

The Corporation and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning regulatory capital amounts and ratios are presented in Note 18 to the consolidated financial statements. As reflected in Note 18, at December 31, 2015 and 2014, the Corporation's and

Bank's capital ratios are well in excess of regulatory capital requirements.

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

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

|   | Current General<br>Risk-Based<br>Capital Rule | New Capital Rule                                      |
|---|---|---|
| Minimum regulatory capital ratios:                                    |   |   |
| Common equity tier 1 capital/ risk-weighted assets (RWA)              | N/A   | 4.5%  |
| Tier 1 capital / RWA  | 4%  | 6%  |
| Total capital / RWA   | 8%  | 8%  |
| Tier 1 capital / Average assets (Leverage ratio)                      | 4%  | 4%  |
| Capital buffers:  |   |   |
| Capital conservation buffer   | N/A   | 2.5% of RWA; composed of common equity tier 1 capital |
| Prompt correction action levels - Common equity tier 1 capital ratio: |   |   |
| Well capitalized  | N/A   | 36.5%   |
| Adequately capitalized  | N/A   | 34.5%   |
| Undercapitalized  | N/A   | <4.5%   |
| Significantly undercapitalized  | N/A   | <3%   |
| Prompt correction action levels - Tier 1 capital ratio:               |   |   |
| Well capitalized  | 36%   | 38%   |
| Adequately capitalized  | 34%   | 36%   |
| Undercapitalized  | <4%   | <6%   |
| Significantly undercapitalized  | <3%   | <4%   |
| Prompt correction action levels - Total capital ratio:                |   |   |
| Well capitalized  | 310%  | 310%  |
| Adequately capitalized  | 38%   | 38%   |
| Undercapitalized  | <8%   | <8%   |
| Significantly undercapitalized  | <6%   | <6%   |
| Prompt correction action levels - Leverage ratio:                     |   |   |
| Well capitalized  | 35%   | 35%   |
| Adequately capitalized  | 34%   | 34%   |
| Undercapitalized  | <4%   | <4%   |
| Significantly undercapitalized  | <3%   | <3%   |
| Prompt correction action levels - Critically undercapitalized:        |   |   |
| Tangible equity to total assets                                       | ≤2%   | ≤2%   |



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

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

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

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

Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. In addition, the Corporation and C&N Bank are subject to restrictions on the amount of dividends that may be paid without approval of banking regulatory authorities. These restrictions are described in Note 18 to the consolidated financial statements.

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

The Corporation's total stockholders' equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in Accumulated Other Comprehensive Income (Loss) within stockholders' equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains (losses) on available-for-sale securities, net of deferred income tax, amounted to \$2,493,000 at December 31, 2015, \$5,281,000 at December 31, 2014 and (\$1,004,000) at December 31, 2013. Changes in accumulated other comprehensive income (loss) are excluded from earnings and directly increase or decrease stockholders' equity. If available-for-sale securities are deemed to be other-than-temporarily impaired, unrealized losses are recorded as a charge against earnings, and amortized cost for the affected securities is reduced. Note 7 to the consolidated financial statements provides additional information concerning management's evaluation of available-for-sale securities for other-than-temporary impairment at December 31, 2015.

Stockholders' equity is also affected by the underfunded or overfunded status of defined benefit pension and postretirement plans. The balance in Accumulated Other Comprehensive Income related to defined benefit plans, net of deferred income tax, was \$35,000 at December 31, 2015, \$79,000 at December 31, 2014 and \$11,000 at December 31, 2013.

## COMPREHENSIVE INCOME

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

Comprehensive Income totaled \$13,639,000 in 2015 as compared to \$23,439,000 in 2014 and \$6,598,000 in 2013. In 2015, Comprehensive Income included: (1) Net Income of \$16,471,000, which was \$615,000 lower than in 2014 and \$2,123,000 lower than in 2013; (2) Other Comprehensive Loss from unrealized losses on available-for-sale securities, net of deferred income tax, of (\$2,788,000) as compared to Other Comprehensive Income of \$6,285,000 in 2014 and Other Comprehensive Loss of \$12,572,000 in 2013; and (3) Other Comprehensive Loss from defined benefit plans of \$44,000 in 2015 as compared to Other Comprehensive Income of \$68,000 in 2014 and Other Comprehensive Income of \$576,000 in 2013. Fluctuations in interest rates significantly affected fair values of available-for-sale securities in 2013 through 2015, and accordingly have an effect on Other Comprehensive Income (Loss) in each year.

## INFLATION

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

maintained their commitment to this policy in their December 16, 2015 statement and anticipates doing so until normalization of the level of the federal funds rate is well under way.

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

## **RECENT ACCOUNTING PRONOUNCEMENTS**

See Note 2 to the consolidated financial statements for a description of recent accounting pronouncements and their recent or potential future effects on the Corporation's financial statements.



## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **MARKET RISK**

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

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

### **INTEREST RATE RISK**

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

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

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

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

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

Table XIV, which follows this discussion, is based on the results of calculations performed using the simulation model as of December 31, 2015 and October 31, 2014. The table shows that as of the respective dates, the changes in net interest income and changes in market value were within the policy limits in all scenarios.

**TABLE XIV - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES****December 31, 2015 Data****(In Thousands)****Period Ending December 31, 2016**

| Basis Point<br>Change in Rates | Interest<br>Income | Interest<br>Expense | Net Interest<br>Income (NII) | NII<br>% Change | NII<br>Risk Limit |      |   |
|--------------------------------|--------------------|---------------------|------------------------------|-----------------|-------------------|------|---|
| +400                           | \$52,181           | \$21,985            | \$ 30,196                    | -20.8           | %                 | 25.0 | % |
| +300                           | 49,687             | 17,282              | 32,405                       | -15.0           | %                 | 20.0 | % |
| +200                           | 47,136             | 12,659              | 34,477                       | -9.6            | %                 | 15.0 | % |
| +100                           | 44,546             | 8,109               | 36,437                       | -4.4            | %                 | 10.0 | % |
| 0                              | 41,835             | 3,715               | 38,120                       | 0.0             | %                 | 0.0  | % |
| -100                           | 39,116             | 3,171               | 35,945                       | -5.7            | %                 | 10.0 | % |
| -200                           | 37,417             | 3,168               | 34,249                       | -10.2           | %                 | 15.0 | % |
| -300                           | 36,838             | 3,168               | 33,670                       | -11.7           | %                 | 20.0 | % |
| -400                           | 36,689             | 3,168               | 33,521                       | -12.1           | %                 | 25.0 | % |

**Market Value of Portfolio Equity at December 31, 2015**

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

**October 31, 2014 Data****(In Thousands)**

**Period Ending October 31, 2015**

| Basis Point<br>Change in Rates | Interest<br>Income | Interest<br>Expense | Net Interest<br>Income (NII) | NII<br>% Change | NII<br>Risk Limit |      |   |
|--------------------------------|--------------------|---------------------|------------------------------|-----------------|-------------------|------|---|
| +400                           | \$55,351           | \$23,123            | \$ 32,228                    | -20.3           | %                 | 25.0 | % |
| +300                           | 52,975             | 18,223              | 34,752                       | -14.1           | %                 | 20.0 | % |
| +200                           | 50,546             | 13,618              | 36,928                       | -8.7            | %                 | 15.0 | % |
| +100                           | 47,977             | 9,330               | 38,647                       | -4.4            | %                 | 10.0 | % |
| 0                              | 45,478             | 5,043               | 40,435                       | 0.0             | %                 | 0.0  | % |
| -100                           | 42,869             | 4,794               | 38,075                       | -5.8            | %                 | 10.0 | % |
| -200                           | 41,095             | 4,729               | 36,366                       | -10.1           | %                 | 15.0 | % |
| -300                           | 40,123             | 4,707               | 35,416                       | -12.4           | %                 | 20.0 | % |
| -400                           | 39,998             | 4,707               | 35,291                       | -12.7           | %                 | 25.0 | % |

**Market Value of Portfolio Equity at October 31, 2014**

| Basis Point<br>Change in Rates | Present<br>Value<br>Equity | Present<br>Value<br>% Change | Present<br>Value<br>Risk Limit |      |   |
|--------------------------------|----------------------------|------------------------------|--------------------------------|------|---|
| +400                           | \$176,447                  | -24.4                        | %                              | 50.0 | % |
| +300                           | 189,184                    | -18.9                        | %                              | 45.0 | % |
| +200                           | 203,838                    | -12.6                        | %                              | 35.0 | % |
| +100                           | 218,314                    | -6.4                         | %                              | 25.0 | % |
| 0                              | 233,255                    | 0.0                          | %                              | 0.0  | % |
| -100                           | 232,818                    | -0.2                         | %                              | 25.0 | % |
| -200                           | 232,294                    | -0.4                         | %                              | 35.0 | % |
| -300                           | 251,791                    | 7.9                          | %                              | 45.0 | % |
| -400                           | 288,059                    | 23.5                         | %                              | 50.0 | % |

**EQUITY SECURITIES RISK**

The Corporation's equity securities portfolio consists of investments in stocks of banks and bank holding companies. Investments in bank stocks are subject to risk factors that affect the banking industry in general, including credit risk, competition from non-bank entities, interest rate risk and other factors, which could result in a decline in market prices. Also, losses could occur in individual stocks held by the Corporation because of specific circumstances related to each bank. As discussed further in Note 7 of the consolidated financial statements, the Corporation had no other-than-temporary impairment losses related to bank stocks in 2015 or 2014.

Equity securities held as of December 31, 2015 and 2014 are presented in Table XV. Table XV presents quantitative data concerning the effects of a decline in fair value of the Corporation's equity securities of 10% or 20%. The data in Table XV does not reflect the effects of any appreciation in value that may occur, nor does it present the Corporation's maximum exposure to loss on equity securities, which would be 100% of their fair value as of December 31, 2015.

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

|  | Dec. 31,<br>2015 | Dec. 31,<br>2014 |
|--|------------------|------------------|
| Cost                                     | \$ 1,680         | \$ 5,605         |
| Fair Value                               | 2,386            | 8,654            |
| Hypothetical 10% Decline In Market Value | (239 )           | (865 )           |
| Hypothetical 20% Decline In Market Value | (477 )           | (1,731 )         |

**ITEM 1. FINANCIAL STATEMENTS****CONSOLIDATED BALANCE SHEETS**

(In Thousands, Except Share and Per Share Data)

|   | December 31,<br>2015 | December 31,<br>2014 |
|---|----------------------|----------------------|
| <b>ASSETS</b>   |                      |                      |
| Cash and due from banks:  |                      |                      |
| Noninterest-bearing   | \$ 14,710            | \$ 14,812            |
| Interest-bearing  | 21,351               | 21,235               |
| Total cash and due from banks   | 36,061               | 36,047               |
| Available-for-sale securities, at fair value  | 420,290              | 516,807              |
| Loans held for sale   | 280                  | 0                    |
| Loans receivable  | 704,880              | 630,545              |
| Allowance for loan losses   | (7,889)              | (7,336)              |
| Loans, net  | 696,991              | 623,209              |
| Bank-owned life insurance   | 20,764               | 22,119               |
| Accrued interest receivable   | 3,768                | 3,908                |
| Bank premises and equipment, net  | 15,406               | 16,256               |
| Foreclosed assets held for sale   | 1,260                | 1,189                |
| Deferred tax asset, net   | 3,115                | 1,668                |
| Intangible asset - Core deposit intangibles   | 30                   | 52                   |
| Intangible asset - Goodwill   | 11,942               | 11,942               |
| Other assets  | 13,510               | 8,766                |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,223,417</b>  | <b>\$ 1,241,963</b>  |
| <b>LIABILITIES</b>  |                      |                      |
| Deposits:   |                      |                      |
| Noninterest-bearing   | \$ 211,041           | \$ 212,439           |
| Interest-bearing  | 724,574              | 755,550              |
| Total deposits  | 935,615              | 967,989              |
| Short-term borrowings   | 53,496               | 5,537                |
| Long-term borrowings  | 38,767               | 73,060               |
| Accrued interest and other liabilities  | 8,052                | 7,015                |
| <b>TOTAL LIABILITIES</b>  | <b>1,035,930</b>     | <b>1,053,601</b>     |
| <b>STOCKHOLDERS' EQUITY</b>   |                      |                      |
| Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; no shares issued at December 31, 2015 and December 31, 2014   | 0                    | 0                    |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2015 and 2014; issued 12,655,171 at December 31, 2015 and December 31, 2014; outstanding 12,180,623 at December 31, 2015 and 12,279,980 December 31, 2014 | 12,655               | 12,655               |
| Paid-in capital   | 71,654               | 71,541               |
| Retained earnings   | 109,454              | 105,550              |

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|  |              |   |              |   |
|--|--------------|---|--------------|---|
| Treasury stock, at cost; 474,548 shares at December 31, 2015 and 375,191 shares at December 31, 2014 | (8,804       | ) | (6,744       | ) |
| Sub-total  | 184,959      |   | 183,002      |   |
| Accumulated other comprehensive income:  |              |   |              |   |
| Unrealized gain on available-for-sale securities   | 2,493        |   | 5,281        |   |
| Defined benefit plans gain   | 35           |   | 79           |   |
| Total accumulated other comprehensive income   | 2,528        |   | 5,360        |   |
| TOTAL STOCKHOLDERS' EQUITY   | 187,487      |   | 188,362      |   |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY   | \$ 1,223,417 |   | \$ 1,241,963 |   |

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

| Consolidated Statements of Income<br>(In Thousands Except Per Share Data)     | Years Ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2015                     | 2014     | 2013     |
| <b>INTEREST INCOME</b>  |                          |          |          |
| Interest and fees on loans  | \$31,311                 | \$32,127 | \$35,484 |
| Interest on balances with depository institutions                             | 93                       | 125      | 105      |
| Interest on loans to political subdivisions                                   | 1,668                    | 1,403    | 1,381    |
| Interest on mortgages held for sale   | 16                       | 16       | 54       |
| Income from available-for-sale securities:                                    |                          |          |          |
| Taxable   | 7,303                    | 7,721    | 6,810    |
| Tax-exempt  | 3,844                    | 4,310    | 4,785    |
| Dividends   | 284                      | 307      | 295      |
| Total interest and dividend income  | 44,519                   | 46,009   | 48,914   |
| <b>INTEREST EXPENSE</b>   |                          |          |          |
| Interest on deposits  | 1,924                    | 2,163    | 2,703    |
| Interest on short-term borrowings   | 32                       | 9        | 9        |
| Interest on long-term borrowings  | 2,646                    | 2,950    | 3,053    |
| Total interest expense  | 4,602                    | 5,122    | 5,765    |
| Net interest income   | 39,917                   | 40,887   | 43,149   |
| Provision for loan losses   | 845                      | 476      | 2,047    |
| Net interest income after provision for loan losses                           | 39,072                   | 40,411   | 41,102   |
| <b>OTHER INCOME</b>   |                          |          |          |
| Service charges on deposit accounts   | 4,864                    | 5,025    | 5,246    |
| Service charges and fees  | 494                      | 538      | 597      |
| Trust and financial management revenue  | 4,626                    | 4,490    | 4,087    |
| Brokerage revenue   | 839                      | 901      | 784      |
| Insurance commissions, fees and premiums                                      | 109                      | 118      | 170      |
| Interchange revenue from debit card transactions                              | 1,935                    | 1,959    | 1,941    |
| Net gains from sale of loans  | 735                      | 768      | 1,969    |
| (Decrease) increase in fair value of servicing rights                         | (162 )                   | (27 )    | 67       |
| Increase in cash surrender value of life insurance                            | 386                      | 376      | 399      |
| Net (loss) gain from premises and equipment                                   | (1 )                     | 8        | (16 )    |
| Other operating income  | 1,579                    | 1,264    | 1,207    |
| Sub-total   | 15,404                   | 15,420   | 16,451   |
| Total other-than-temporary impairment losses on available-for-sale securities | 0                        | 0        | (25 )    |
| Portion of (gain) recognized in other comprehensive loss (before taxes)       | 0                        | 0        | 0        |
| Net impairment losses recognized in earnings                                  | 0                        | 0        | (25 )    |
| Realized gains on available-for-sale securities, net                          | 2,861                    | 1,104    | 1,743    |
| Total other income  | 18,265                   | 16,524   | 18,169   |
| <b>OTHER EXPENSES</b>   |                          |          |          |
| Salaries and wages  | 14,682                   | 15,121   | 14,206   |
| Pensions and other employee benefits  | 4,420                    | 4,769    | 4,150    |
| Occupancy expense, net  | 2,574                    | 2,628    | 2,473    |
| Furniture and equipment expense   | 1,860                    | 1,859    | 1,948    |
| FDIC Assessments  | 603                      | 600      | 604      |
| Pennsylvania shares tax   | 1,174                    | 1,350    | 1,402    |
| Professional fees   | 538                      | 699      | 1,534    |



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|  |          |          |          |
|--|----------|----------|----------|
| Automated teller machine and interchange expense | 988      | 924      | 1,020    |
| Software subscriptions                           | 876      | 784      | 836      |
| Loss on prepayment of debt                       | 2,573    | 0        | 1,023    |
| Other operating expense                          | 5,241    | 5,423    | 5,298    |
| Total other expenses                             | 35,529   | 34,157   | 34,494   |
| Income before income tax provision               | 21,808   | 22,778   | 24,777   |
| Income tax provision                             | 5,337    | 5,692    | 6,183    |
| NET INCOME                                       | \$16,471 | \$17,086 | \$18,594 |
| NET INCOME PER SHARE - BASIC                     | \$1.35   | \$1.38   | \$1.51   |
| NET INCOME PER SHARE - DILUTED                   | \$1.35   | \$1.38   | \$1.50   |

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

**Consolidated Statements of Comprehensive Income****(In Thousands)**

|  | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2015                     | 2014     | 2013     |
| Net income   | \$16,471                 | \$17,086 | \$18,594 |
| Unrealized (losses) gains on available-for-sale securities:  |                          |          |          |
| Unrealized holding (losses) gains on available-for-sale securities   | (1,429 )                 | 10,774   | (17,623) |
| Reclassification adjustment for gains realized in income   | (2,861 )                 | (1,104 ) | (1,718 ) |
| Other comprehensive (loss) gain on available-for-sale securities   | (4,290 )                 | 9,670    | (19,341) |
| Unfunded pension and postretirement obligations:   |                          |          |          |
| Changes from plan amendments and actuarial gains and losses included in accumulated other comprehensive (loss) gain                            | (135 )                   | (79 )    | 885      |
| Amortization of net transition obligation, prior service cost, net actuarial loss and loss on settlement included in net periodic benefit cost | 67                       | 184      | 2        |
| Other comprehensive (loss) gain on unfunded retirement obligations   | (68 )                    | 105      | 887      |
| Other comprehensive (loss) income before income tax  | (4,358 )                 | 9,775    | (18,454) |
| Income tax related to other comprehensive loss (income)  | 1,526                    | (3,422 ) | 6,458    |
| Net other comprehensive (loss) income  | (2,832 )                 | 6,353    | (11,996) |
| Comprehensive income   | \$13,639                 | \$23,439 | \$6,598  |

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

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

|   | Common<br>Shares | Treasury<br>Shares | Common<br>Stock | Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury<br>Stock | Total     |
|---|------------------|--------------------|-----------------|--------------------|----------------------|---|-------------------|-----------|
| Balance, January 1,<br>2013   | 12,525,411       | 251,376            | \$ 12,525       | \$68,622           | \$94,839             | \$ 11,003                                       | \$(4,203 )        | \$182,786 |
| Net income  |                  |                    |                 |                    | 18,594               |   |                   | 18,594    |
| Other comprehensive<br>loss, net  |                  |                    |                 |                    |                      | (11,996 )                                       |                   | (11,996 ) |
| Cash dividends<br>declared on common<br>stock, \$1.00 per share           |                  |                    |                 |                    | (12,343 )            |   |                   | (12,343 ) |
| Shares issued for<br>dividend reinvestment<br>Plan                        | 71,129           |                    | 71              | 1,356              |                      |   |                   | 1,427     |
| Shares issued from<br>treasury related to<br>exercise of stock<br>options |                  | (10,656 )          |                 | 5                  |                      |   | 179               | 184       |
| Restricted stock<br>granted   |                  | (37,886 )          |                 | (633 )             |                      |   | 633               | 0         |
| Forfeiture of restricted<br>stock   |                  | 3,643              |                 | 61                 |                      |   | (61 )             | 0         |
| Stock-based<br>compensation expense                                       |                  |                    |                 | 696                |                      |   |                   | 696       |
| Tax effect of stock<br>option exercises                                   |                  |                    |                 | (2 )               |                      |   |                   | (2 )      |
| Tax benefit from<br>employee benefit plan                                 |                  |                    |                 |                    | 126                  |   |                   | 126       |
| Balance, December<br>31, 2013   | 12,596,540       | 206,477            | 12,596          | 70,105             | 101,216              | (993 )  | (3,452 )          | 179,472   |
| Net income  |                  |                    |                 |                    | 17,086               |   |                   | 17,086    |
| Other comprehensive<br>income, net  |                  |                    |                 |                    |                      | 6,353   |                   | 6,353     |
| Cash dividends<br>declared on common<br>stock, \$1.04 per share           |                  |                    |                 |                    | (12,889 )            |   |                   | (12,889 ) |
| Shares issued for<br>dividend reinvestment<br>Plan                        | 59,498           | (18,473 )          | 60              | 1,069              |                      |   | 368               | 1,497     |
| Treasury stock<br>purchased   |                  | 208,300            |                 |                    |                      |   | (4,002 )          | (4,002 )  |

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|   |            |           |          |          |           |          |  |            |           |
|---|------------|-----------|----------|----------|-----------|----------|--|------------|-----------|
| Shares issued from treasury related to exercise of stock options              | (867 )     | (11,860 ) | (1 )     | (64 )    |           |          |  | 188        | 123       |
| Restricted stock granted  |            | (16,711 ) |          | (279 )   |           |          |  | 279        | 0         |
| Forfeiture of restricted stock  |            | 7,458     |          | 125      |           |          |  | (125 )     | 0         |
| Stock-based compensation expense  |            |           |          | 565      |           |          |  |            | 565       |
| Tax benefit from dividends on restricted stock                                |            |           |          | (1 )     |           |          |  |            | (1 )      |
| Tax effect of stock option exercises  |            |           |          | 21       |           |          |  |            | 21        |
| Tax benefit from employee benefit plan  |            |           |          |          |           | 137      |  |            | 137       |
| Balance, December 31, 2014  | 12,655,171 | 375,191   | 12,655   | 71,541   | 105,550   | 5,360    |  | (6,744 )   | 188,362   |
| Net income  |            |           |          |          | 16,471    |          |  |            | 16,471    |
| Other comprehensive loss, net   |            |           |          |          |           | (2,832 ) |  |            | (2,832 )  |
| Cash dividends declared on common stock, \$1.04 per share                     |            |           |          |          | (12,710 ) |          |  |            | (12,710 ) |
| Shares issued for dividend reinvestment Plan                                  |            | (73,810 ) |          | 86       |           |          |  | 1,379      | 1,465     |
| Treasury stock purchased  |            | 226,900   |          |          |           |          |  | (4,415 )   | (4,415 )  |
| Shares issued from treasury and redeemed related to exercise of stock options |            | (22,435 ) |          | (27 )    |           |          |  | 408        | 381       |
| Restricted stock granted  |            | (34,800 ) |          | (627 )   |           |          |  | 627        | 0         |
| Forfeiture of restricted stock  |            | 3,502     |          | 59       |           |          |  | (59 )      | 0         |
| Stock-based compensation expense  |            |           |          | 606      |           |          |  |            | 606       |
| Tax effect of stock option exercises  |            |           |          | (6 )     |           |          |  |            | (6 )      |
| Tax benefit from dividends on restricted stock                                |            |           |          | 22       |           |          |  |            | 22        |
| Tax benefit from employee benefit plan  |            |           |          |          |           | 143      |  |            | 143       |
| Balance, December 31, 2015  | 12,655,171 | 474,548   | \$12,655 | \$71,654 | \$109,454 | \$ 2,528 |  | \$(8,804 ) | \$187,487 |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS****(In Thousands)**

|   | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2015                     | 2014      | 2013      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                          |           |           |
| Net income  | \$ 16,471                | \$ 17,086 | \$ 18,594 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |           |           |
| Provision for loan losses   | 845                      | 476       | 2,047     |
| Realized gains on available-for-sale securities, net                              | (2,861 )                 | (1,104 )  | (1,718 )  |
| Loss on prepayment of debt  | 2,573                    | 0         | 1,023     |
| Realized (gain) loss on foreclosed assets   | (84 )                    | (136 )    | 71        |
| Loss (gain) on disposition of premises and equipment                              | 1                        | (8 )      | 16        |
| Depreciation expense  | 1,888                    | 1,940     | 2,020     |
| Accretion and amortization on securities, net                                     | 1,562                    | 1,375     | 1,836     |
| Accretion and amortization on loans and deposits, net                             | (21 )                    | (27 )     | (32 )     |
| Decrease (increase) in fair value of servicing rights                             | 162                      | 27        | (67 )     |
| Increase in cash surrender value of life insurance                                | (386 )                   | (376 )    | (399 )    |
| Gain on life insurance benefits   | (212 )                   | 0         | 0         |
| Stock-based compensation  | 606                      | 565       | 696       |
| Amortization of core deposit intangibles  | 22                       | 35        | 51        |
| Deferred income taxes   | 79                       | 1,254     | 1,839     |
| Gains on sales of loans, net  | (735 )                   | (768 )    | (1,969 )  |
| Origination of loans for sale   | (21,823)                 | (21,680 ) | (58,427 ) |
| Proceeds from sales of loans  | 22,101                   | 22,317    | 62,436    |
| (Increase) decrease in accrued interest receivable and other assets               | (1,697 )                 | 1,395     | 3,234     |
| Increase (decrease) in accrued interest payable and other liabilities             | 1,195                    | (90 )     | (679 )    |
| Net Cash Provided by Operating Activities   | 19,686                   | 22,281    | 30,572    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                          |           |           |
| Proceeds from maturities of certificates of deposit                               | 1,780                    | 2,560     | 480       |
| Purchase of certificates of deposit   | (100 )                   | (960 )    | (1,688 )  |
| Proceeds from sales of available-for-sale securities                              | 44,504                   | 56,269    | 25,500    |
| Proceeds from calls and maturities of available-for-sale securities               | 89,159                   | 78,101    | 97,123    |
| Purchase of available-for-sale securities   | (40,363)                 | (158,894) | (152,163) |
| Redemption of Federal Home Loan Bank of Pittsburgh stock                          | 5,029                    | 2,804     | 2,680     |
| Purchase of Federal Home Loan Bank of Pittsburgh stock                            | (8,102 )                 | (602 )    | (1,624 )  |
| Net (increase) decrease in loans  | (77,129)                 | 10,317    | 39,059    |
| Proceeds from bank-owned life insurance   | 1,953                    | 0         | 0         |
| Purchase of premises and equipment  | (1,039 )                 | (801 )    | (801 )    |
| Proceeds from disposition of premises and equipment                               | 0                        | 43        | 42        |
| Purchase of investment in limited liability company                               | 0                        | 0         | (147 )    |
| Return of principal on limited liability entity investments                       | 181                      | 173       | 164       |
| Proceeds from sale of foreclosed assets   | 2,536                    | 1,504     | 255       |
| Net Cash Provided by (Used in) Investing Activities                               | 18,409                   | (9,486 )  | 8,880     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                          |           |           |
| Net (decrease) increase in deposits   | (32,374)                 | 13,473    | (51,590 ) |

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|   |                 |                 |                  |
|---|-----------------|-----------------|------------------|
| Net increase (decrease) in short-term borrowings          | 47,959          | (17,848 )       | 17,818           |
| Repayments of long-term borrowings                        | (36,866)        | (278 )          | (11,497 )        |
| Purchase of treasury stock                                | (4,415 )        | (4,002 )        | 0                |
| Sale of treasury stock                                    | 381             | 123             | 184              |
| Tax benefit from compensation plans                       | 159             | 157             | 124              |
| Common dividends paid                                     | (11,245)        | (11,392 )       | (10,916 )        |
| Net Cash Used in Financing Activities                     | (36,401)        | (19,767 )       | (55,877 )        |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>   | <b>1,694</b>    | <b>(6,972 )</b> | <b>(16,425 )</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>       | <b>31,619</b>   | <b>38,591</b>   | <b>55,016</b>    |
| <b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>             | <b>\$33,313</b> | <b>\$31,619</b> | <b>\$38,591</b>  |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b> |                 |                 |                  |
| Assets acquired through foreclosure of real estate loans  | \$2,523         | \$1,665         | \$339            |
| Accrued purchase of available-for-sale securities         | \$0             | \$226           | \$0              |
| Interest paid   | \$4,636         | \$5,138         | \$5,782          |
| Income taxes paid   | \$4,827         | \$4,432         | \$4,213          |

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**BASIS OF CONSOLIDATION** - 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. All material intercompany balances and transactions have been eliminated in consolidation.

**NATURE OF OPERATIONS** - The Corporation is primarily engaged in providing a full range of banking and mortgage services to individual and corporate customers in North Central Pennsylvania and Southern New York State. Lending products include mortgage loans, commercial loans and consumer loans, as well as specialized instruments such as commercial letters-of-credit. Deposit products include various types of checking accounts, passbook and statement savings, money market accounts, interest checking accounts, Individual Retirement Accounts and certificates of deposit. The Corporation also offers non-insured “RepoSweep” accounts.

The Corporation provides Trust and Financial Management services, including administration of trusts and estates, retirement plans, and other employee benefit plans, and investment management services. The Corporation offers a variety of personal and commercial insurance products through C&N Financial Services Corporation. C&N Financial Services Corporation also offers mutual funds, annuities, educational savings accounts and other investment products through registered agents. Management has determined that the Corporation has one reportable segment, “Community Banking.” All of the Corporation’s activities are interrelated, and each activity is dependent and assessed based on how each of the activities of the Corporation supports the others.

The Corporation is subject to competition from other financial institutions. It is also subject to regulation by certain federal and state agencies and undergoes periodic examination by those regulatory authorities. As a consequence, the Corporation’s business is particularly susceptible to being affected by future federal and state legislation and regulations.

**USE OF ESTIMATES** - The financial information is presented in accordance with generally accepted accounting principles and general practice for financial institutions in the United States of America (“U.S. GAAP”). In preparing financial statements, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements. In addition, these estimates and assumptions affect revenues and expenses in the financial statements and as such, actual



results could differ from those estimates.

Material estimates that are particularly susceptible to change include: (1) the allowance for loan losses, (2) fair values of debt securities based on estimates from independent valuation services or from brokers, (3) assessment of impaired securities to determine whether or not the securities are other-than-temporarily impaired, (4) valuation of deferred tax assets and (5) valuation of obligations from defined benefit plans.

**INVESTMENT SECURITIES** - Investment securities are accounted for as follows:

**Available-for-sale securities** - includes debt securities not classified as held-to-maturity or trading, and unrestricted equity securities. Such securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported separately through accumulated other comprehensive income, net of tax. Amortization of premiums and accretion of discounts on available-for-sale securities are recorded using the level yield method over the remaining contractual life of the securities, adjusted for actual prepayments. Realized gains and losses on sales of available-for-sale securities are computed on the basis of specific identification of the adjusted cost of each security. Securities within the available-for-sale portfolio may be used as part of the Corporation's asset and liability management strategy and may be sold in response to changes in interest rate risk, prepayment risk or other factors.

**Other-than-temporary impairment** - Declines in the fair value of available-for-sale securities that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (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, (3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value, and (4) whether the Corporation intends to sell the security or if it is more likely than not that the Corporation will be required to sell the security before the recovery of its amortized cost basis. The credit-related impairment is recognized in earnings and is the difference between a security's amortized cost basis and the present value of expected future cash flows discounted at the security's effective interest rate. For debt securities classified as held-to-maturity, if any, the amount of noncredit-related impairment is recognized in other comprehensive income and accreted over the remaining life of the debt security as an increase in the carrying value of the security. In addition, the risk of future other-than-temporary impairment may be influenced by additional bank failures, prolonged recession in the U.S. economy, changes to real estate values, interest deferrals and whether the federal government provides assistance to financial institutions.

**Restricted equity securities** - Restricted equity securities consist primarily of Federal Home Loan Bank of Pittsburgh stock, and are carried at cost and evaluated for impairment. Holdings of restricted equity securities are included in Other Assets in the Consolidated Balance Sheet, and dividends received on restricted securities are included in Other Income in the Consolidated Statement of Income.

**LOANS HELD FOR SALE** - Mortgage loans held for sale are reported at the lower of cost or market, determined in the aggregate.

**LOANS RECEIVABLE** - Loans receivable which management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at unpaid principal balances, less the allowance for loan losses and net deferred loan fees. Interest income is accrued on the unpaid principal balance. Loan origination and commitment fees, as well as certain direct origination costs, are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method.

The loans receivable portfolio is segmented into residential mortgage, commercial and consumer loans. The residential mortgage segment includes the following classes: first and junior lien residential mortgages, home equity lines of credit and residential construction loans. The most significant classes of commercial loans are commercial loans secured by real estate, non-real estate secured commercial and industrial loans, loans to political subdivisions, commercial construction, and loans secured by farmland.

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

**ALLOWANCE FOR LOAN LOSSES** - The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential

consumer loans are generally charged off no later than when they are 120 days past due on a contractual basis, or earlier in the event of bankruptcy or if there is an amount deemed uncollectible.

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 addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination. In the process of evaluating the loan portfolio, management also considers the Corporation's exposure to losses from unfunded loan commitments. As of December 31, 2015 and 2014, management determined that no allowance for credit losses related to unfunded loan commitments was required.

The allowance consists primarily of two major components – (1) a specific component based on a detailed assessment of certain larger loan relationships, mainly commercial purpose, determined 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.

The specific component relates to loans that are classified as impaired based on a detailed assessment of certain larger loan relationships evaluated by a management committee referred to as the Watch List Committee. Specific loan relationships are identified for evaluation based on the related credit risk rating. For individual loans classified as impaired, an allowance is established when the collateral value less estimated selling costs, present value of discounted cash flows or observable market price of the impaired loan is lower than the carrying value of that loan.

The general component covers pools of loans by loan class including commercial loans not considered individually impaired, as well as smaller balance homogeneous classes of loans, such as residential real estate, home equity lines of credit and other consumer loans. Accordingly, the Corporation generally does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are subject to a restructuring agreement. The pools of loans for each loan segment are evaluated for loss exposure based upon average historical net charge-off rates (currently thirty-six months), adjusted for qualitative factors. Qualitative risk factors (described in the following paragraph) are evaluated for the impact on each of the three distinct 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. Any adjustments to the factors are supported by a narrative documentation of changes in conditions accompanying the allowance for loan loss calculation.

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 57% at December 31, 2015) are secured by real estate, and accordingly, the Corporation's risk for the commercial segment is significantly affected by commercial real estate values. The consumer segment includes a wide mix of loans for different purposes, primarily secured loans, including loans secured by motor vehicles, manufactured housing and other types of collateral.

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

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. 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 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 agings 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.

Loans whose terms are modified are classified as troubled debt restructurings if the Corporation grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve reductions in required payments, an extension of a loan's stated maturity date or a temporary reduction in interest rate. Non-accrual troubled debt restructurings may be restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

**BANK PREMISES AND EQUIPMENT** - Bank premises and equipment are stated at cost less accumulated depreciation. Repair and maintenance expenditures which extend the useful lives of assets are capitalized, and other repair and maintenance expenditures are expensed as incurred. Depreciation expense is computed using the straight-line method.

**IMPAIRMENT OF LONG-LIVED ASSETS** - The Corporation reviews long-lived assets, such as premises and equipment and intangibles, for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. These changes in circumstances may include a significant decrease in the market value of an asset or the manner in which an asset is used. If there is an indication the carrying value of an asset may not be recoverable, future undiscounted cash flows expected to result from use of the asset are estimated. If the sum of the expected cash flows is less than the carrying value of the asset, a loss is recognized for the difference between the carrying value and fair market value of the asset.

**INTEREST COSTS** - The Corporation capitalizes interest as a component of the cost of premises and equipment constructed or acquired for its own use. The amount of capitalized interest in 2015, 2014, and 2013 was not significant.

**FORECLOSED ASSETS HELD FOR SALE** - Foreclosed assets held for sale consist of real estate acquired by foreclosure and are initially recorded at fair value, less estimated selling costs.

**GOODWILL AND CORE DEPOSIT INTANGIBLE ASSETS** - Goodwill represents the excess of the cost of acquisitions over the fair value of the net assets acquired. Goodwill is tested at least annually for impairment, or more often if events or circumstances indicate there may be impairment. Core deposit intangibles are being amortized over periods of time that represent the expected lives using a method of amortization that reflects the pattern of economic benefit. Core deposit intangibles are subject to impairment testing whenever events or changes in circumstances indicate their carrying amounts may not be recoverable.

**SERVICING RIGHTS** - The estimated fair value of servicing rights related to mortgage loans sold and serviced by the Corporation is recorded as an asset upon the sale of such loans. The valuation of servicing rights is adjusted quarterly, with changes in fair value included in Other Operating Income in the consolidated statements of operations. Significant inputs to the valuation include expected net servicing income to be received, the expected life of the underlying loans and the discount rate. The servicing rights asset is included in Other Assets in the consolidated balance sheet, with a balance equal to fair value of \$1,296,000 at December 31, 2015 and \$1,281,000 at December 31, 2014.

**INCOME TAXES** - Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax bases given the provisions of the enacted tax laws. Deferred tax assets are reduced, if necessary, by the amount of such benefits that are not expected to be realized based upon available evidence. Tax benefits from investments in limited partnerships that have qualified for federal low-income tax credits are recognized as a reduction in the provision for income tax over the term of the investment using the effective yield method. The Corporation includes income tax penalties in the provision for income tax. The Corporation has no accrued interest related to unrecognized tax benefits.

**STOCK COMPENSATION PLANS** - The Corporation's stock-based compensation policy applies to all forms of stock-based compensation including stock options and restricted stock units. All stock-based compensation is accounted for under the fair value method as required by generally accepted accounting principles in the United States. The expense associated with stock-based compensation is recognized over the vesting period of each individual arrangement.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option valuation model. The fair value of restricted stock is based on the current market price on the date of grant.

**OFF-BALANCE SHEET FINANCIAL INSTRUMENTS** - In the ordinary course of business, the Corporation has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

**CASH FLOWS** - The Corporation utilizes the net reporting of cash receipts and cash payments for certain deposit and lending activities. Cash equivalents include federal funds sold and all cash and amounts due from depository institutions and interest-bearing deposits in other banks with original maturities of three months or less.

**TRUST ASSETS AND INCOME** - Assets held by the Corporation in a fiduciary or agency capacity for its customers are not included in the financial statements since such items are not assets of the Corporation. Trust income is recorded on a cash basis, which is not materially different from the accrual basis.

## **2. RECENT ACCOUNTING PRONOUNCEMENTS:**

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

In January 2014, the FASB issued ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. This Update provides guidance on accounting for investments in flow-through limited liability entities that qualify for the federal low-income housing tax credit. Prior to ASU 2014-01, under U.S. GAAP, a reporting entity that invests in a qualified affordable housing project could elect to account for that investment using the effective yield method if certain conditions are met, or alternatively, the investment would be accounted for under either the equity method or the cost method. Generally, investors in qualified affordable housing project investments expect to receive all of their return through the receipt of tax credits and tax deductions from operating losses, and use of the effective yield method results in recognition of the return as a reduction of income tax expense over the period of the investment. The amendments in this Update modify the conditions that a reporting entity must meet to be eligible to use a method other than the equity or cost methods to account for investments in qualified affordable housing projects. Additionally, the amendments introduce new recurring disclosure requirements about investments in qualified affordable housing projects. The amendments in this Update became effective for the Corporation for annual and interim periods beginning in the first quarter 2015, and are to be applied retrospectively. Information concerning the Corporation's investments in qualified affordable housing projects is provided in Note 14 to these consolidated financial statements.





In January 2014, the FASB issued ASU 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The objective of the amendments in this Update is to reduce diversity among reporting entities by clarifying when an in substance foreclosure occurs. The amendments in this Update clarify that an in substance foreclosure occurs, and a creditor is considered to have received physical possession of residential real property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to the requirements of the applicable jurisdiction. An entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method. Under the modified retrospective transition method, an entity would record a cumulative-effect adjustment to residential consumer mortgage loans and foreclosed residential real estate properties existing as of the beginning of the annual period for which the amendments are effective. For prospective transition, an entity would apply the amendments to all instances of an entity receiving physical possession of residential real estate property collateralizing consumer mortgage loans that occur after the date of adoption. Early adoption is permitted. The amendments in this Update became effective for the Corporation for annual and interim periods beginning in the first quarter 2015. The Corporation has applied the amendments to its accounting and reporting practices prospectively in the first quarter 2015. Disclosures required by this Update are provided in Note 8 to these consolidated financial statements.

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

In June 2014, the FASB issued ASU 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. In addition to various other amendments that will affect accounting and disclosures for transactions in which the Corporation has not engaged to date, this Update requires expanded disclosures for repurchase agreements that are accounted for as secured borrowings, including: (1) a disaggregation of the gross obligation by the class of collateral pledged, (2) the remaining contractual tenor of the agreements and (3) a discussion of the potential risks associated with the agreements and the related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed. The expanded disclosure requirements associated with repurchase agreements are effective for the Corporation for annual and interim periods beginning in the second quarter 2015. Information concerning the Corporation's repurchase agreements is provided in Note 12 to these

consolidated financial statements.

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

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Liabilities. This makes significant changes in U.S. GAAP related to certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The changes provided for in this Update that are applicable to the Corporation are as follows: (1) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; however, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) for equity investments without readily determinable fair values, require a qualitative assessment to identify impairment, and if a qualitative assessment indicates that impairment exists, requiring an entity to measure the investment at fair value; (3) eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (4) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments (at December 31, 2015 and 2014, the Corporation has no liabilities for which the fair value measurement option has been elected); (6) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (7) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The amendments in this Update will become effective for the Corporation for annual and interim periods beginning in the first quarter 2018. With limited exceptions, early adoption of the amendments in this Update is not permitted. Amendments are to be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values should be applied prospectively.

### 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 (loss) income. The components of other comprehensive (loss) income, and the related tax effects, are as follows:

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| 2015   |                      |                         |                      |
| Unrealized losses on available-for-sale securities:        |                      |                         |                      |
| Unrealized holding losses on available-for-sale securities | \$ (1,429 )          | \$ 500                  | \$ (929 )            |
| Reclassification adjustment for (gains) realized in income | (2,861 )             | 1,002                   | (1,859 )             |
| Other comprehensive loss on available-for-sale securities  | (4,290 )             | 1,502                   | (2,788 )             |

|  |             |          |             |
|--|-------------|----------|-------------|
| Unfunded pension and postretirement obligations:   |             |          |             |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income   | (135 )      | 47       | (88 )       |
| Amortization of net transition obligation, prior service cost, net actuarial loss and loss on settlement included in net periodic benefit cost | 67          | (23 )    | 44          |
| Other comprehensive loss on unfunded retirement obligations  | (68 )       | 24       | (44 )       |
| Total other comprehensive loss   | \$ (4,358 ) | \$ 1,526 | \$ (2,832 ) |

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| 2014   |                      |                         |                      |
| Unrealized gains on available-for-sale securities:   |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities  | \$ 10,774            | \$ (3,771 )             | \$ 7,003             |
| Reclassification adjustment for (gains) realized in income   | (1,104 )             | 386                     | (718 )               |
| Other comprehensive income on available-for-sale securities  | 9,670                | (3,385 )                | 6,285                |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income   | (79 )                | 28                      | (51 )                |
| Amortization of net transition obligation, prior service cost, net actuarial loss and loss on settlement included in net periodic benefit cost | 184                  | (65 )                   | 119                  |
| Other comprehensive income on unfunded retirement obligations  | 105                  | (37 )                   | 68                   |
| Total other comprehensive income   | \$ 9,775             | \$ (3,422 )             | \$ 6,353             |

| (In Thousands)   | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| 2013   |                      |                         |                      |
| Unrealized (losses) on available-for-sale securities:  |                      |                         |                      |
| Unrealized holding losses on available-for-sale securities   | \$ (17,623 )         | \$ 6,168                | \$ (11,455 )         |
| Reclassification adjustment for (gains) realized in income   | (1,718 )             | 601                     | (1,117 )             |
| Other comprehensive loss on available-for-sale securities  | (19,341 )            | 6,769                   | (12,572 )            |
| Unfunded pension and postretirement obligations:   |                      |                         |                      |
| Changes from plan amendments and actuarial gains and losses included in other comprehensive income                         | 885                  | (310 )                  | 575                  |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 2                    | (1 )                    | 1                    |
| Other comprehensive income on unfunded retirement obligations  | 887                  | (311 )                  | 576                  |
| Total other comprehensive loss   | \$ (18,454 )         | \$ 6,458                | \$ (11,996 )         |

Changes in the components of accumulated other comprehensive income, included in stockholders' equity, are as follows:

| (In Thousands)   | Unrealized<br>Holding Gains<br>(Losses)<br>on Securities | Unfunded<br>Pension and<br>Postretirement<br>Obligations | Accumulated<br>Other<br>Comprehensive<br>Income |
|--|--|--|---|
| 2015   |  |  |   |
| Balance, beginning of period                                     | \$ 5,281   | \$ 79  | \$ 5,360  |
| Other comprehensive loss before reclassifications                | (929 )   | (88 )  | (1,017 )  |
| Amounts reclassified from accumulated other comprehensive income | (1,859 )   | 44   | (1,815 )  |
| Other comprehensive loss   | (2,788 )   | (44 )  | (2,832 )  |
| Balance, end of period   | \$ 2,493   | \$ 35  | \$ 2,528  |
| 2014   |  |  |   |
| Balance, beginning of period                                     | \$ (1,004 )  | \$ 11  | \$ (993 )                                       |
| Other comprehensive income before reclassifications              | 7,003  | (51 )  | 6,952   |
| Amounts reclassified from accumulated other comprehensive income | (718 )   | 119  | (599 )  |
| Other comprehensive income                                       | 6,285  | 68   | 6,353   |
| Balance, end of period   | \$ 5,281   | \$ 79  | \$ 5,360  |
| 2013   |  |  |   |
| Balance, beginning of period                                     | \$ 11,568  | \$ (565 )  | \$ 11,003                                       |
| Other comprehensive (loss) income before reclassifications       | (11,455 )  | 575  | (10,880 )                                       |

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|  |           |   |       |         |   |
|--|-----------|---|-------|---------|---|
| Amounts reclassified from accumulated other comprehensive loss | (1,117    | ) | 1     | (1,116  | ) |
| Other comprehensive (loss) income                              | (12,572   | ) | 576   | (11,996 | ) |
| Balance, end of period   | \$ (1,004 | ) | \$ 11 | \$ (993 | ) |

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

For the Year Ended December 31, 2015

(In Thousands)

| Details about Accumulated Other Comprehensive Income Components   | Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Consolidated Statements of Income |
|---|--|---|
| Unrealized gains and losses on available-for-sale securities      | \$ (2,861)   | ) Realized gains on available-for-sale securities, net      |
|   | 1,002  | ) Income tax provision                                      |
|   | (1,859)  | ) Net of tax  |
| Amortization of defined benefit pension and postretirement items: |  |   |
| Prior service cost  | (31)   | ) Pensions and other employee benefits                      |
| Actuarial loss  | 11   | ) Pensions and other employee benefits                      |
| Loss on settlement  | 87   | ) Pensions and other employee benefits                      |
|   | 67   | ) Total before tax  |
|   | (23)   | ) Income tax provision                                      |
|   | 44   | ) Net of tax  |
| Total reclassifications for the period                            | \$ (1,815)   | )   |

For the Year Ended December 31, 2014

(In Thousands)

| Details about Accumulated Other Comprehensive Income Components   | Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Consolidated Statements of Income |
|---|--|---|
| Unrealized gains and losses on available-for-sale securities      | \$ (1,104)   | ) Realized gains on available-for-sale securities, net      |
|   | 386  | ) Income tax provision                                      |
|   | (718)  | ) Net of tax  |
| Amortization of defined benefit pension and postretirement items: |  |   |
| Prior service cost  | (31)   | ) Pensions and other employee benefits                      |
| Actuarial loss  | 19   | ) Pensions and other employee benefits                      |
| Loss on settlement  | 196  | ) Pensions and other employee benefits                      |
|   | 184  | ) Total before tax  |
|   | (65)   | ) Income tax provision                                      |
|   | 119  | ) Net of tax  |
| Total reclassifications for the period                            | \$ (599)   | )   |

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For the Year Ended December 31, 2013  
(In Thousands)

| Details about Accumulated Other<br>Comprehensive Income Components   | Reclassified from<br>Accumulated<br>Other<br>Comprehensive<br>Income | Affected Line Item in the Consolidated<br>Statements of Income                   |
|--|--|--|
| Unrealized gains and losses on<br>available-for-sale Securities      | \$ 25  | Total other-than-temporary impairment losses on<br>available-for-sale securities |
|  | (1,743   | ) Realized gains on available-for-sale securities,<br>net                        |
|  | (1,718   | ) Total before tax   |
|  | 601  | Income tax provision   |
|  | (1,117   | ) Net of tax   |
| Amortization of defined benefit pension and<br>postretirement items: |  |  |
| Prior service cost   | (31  | ) Pensions and other employee benefits   |
| Actuarial loss   | 33   | Pensions and other employee benefits   |
|  | 2  | Total before tax   |
|  | (1   | ) Income tax provision   |
|  | 1  | Net of tax   |
| Total reclassifications for the period                               | \$ (1,116  | )  |



**4. PER SHARE DATA**

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

|   | Net<br>Income | Weighted-<br>Average<br>Common<br>Shares | Earnings<br>Per<br>Share |
|---|---------------|--|--------------------------|
| 2015  |               |  |                          |
| Earnings per share – basic  | \$ 16,471,000 | 12,211,941                               | \$ 1.35                  |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 210,402                                  |                          |
| Hypothetical share repurchase at \$20.04                              |               | (188,570 )                               |                          |
| Earnings per share – diluted  | \$ 16,471,000 | 12,233,773                               | \$ 1.35                  |
| 2014  |               |  |                          |
| Earnings per share – basic  | \$ 17,086,000 | 12,390,067                               | \$ 1.38                  |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 224,015                                  |                          |
| Hypothetical share repurchase at \$19.41                              |               | (202,032 )                               |                          |
| Earnings per share – diluted  | \$ 17,086,000 | 12,412,050                               | \$ 1.38                  |
| 2013  |               |  |                          |
| Earnings per share – basic  | \$ 18,594,000 | 12,352,383                               | \$ 1.51                  |
| Dilutive effect of potential common stock arising from stock options: |               |  |                          |
| Exercise of outstanding stock options                                 |               | 250,236                                  |                          |
| Hypothetical share repurchase at \$19.86                              |               | (219,829 )                               |                          |
| Earnings per share – diluted  | \$ 18,594,000 | 12,382,790                               | \$ 1.50                  |

Stock options that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 61,590 shares in 2015, 151,310 shares in 2014 and 88,521 shares in 2013.

**5. CASH AND DUE FROM BANKS**

Cash and due from banks at December 31, 2015 and 2014 include the following:

| (In thousands)                | Dec. 31,<br>2015 | Dec. 31,<br>2014 |
|-------------------------------|------------------|------------------|
| Cash and cash equivalents     | \$33,313         | \$31,619         |
| Certificates of deposit       | 2,748            | 4,428            |
| Total cash and due from banks | \$36,061         | \$36,047         |

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. The reserves are based on deposit levels, account activity, and other services provided by the Federal Reserve Bank. Required reserves were \$15,327,000 at December 31, 2015 and \$16,853,000 at December 31, 2014.

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

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

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

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

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

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

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At December 31, 2015 and 2014, assets measured at fair value and the valuation methods used are as follows:

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

| (In Thousands)   | December 31, 2014                                     |  |                                     |                        |
|--|---|--|-------------------------------------|------------------------|
|  | Quoted<br>Prices<br>in Active<br>Markets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair<br>Value |
| Recurring fair value measurements  |   |  |                                     |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>                                      |   |  |                                     |                        |
| Obligations of U.S. Government agencies                                    | \$ 0  | \$ 26,676                                  | \$ 0                                | \$ 26,676              |
| Obligations of states and political subdivisions:                          |   |  |                                     |                        |
| Tax-exempt   | 0   | 124,839                                    | 0                                   | 124,839                |
| Taxable  | 0   | 33,878                                     | 0                                   | 33,878                 |
| Mortgage-backed securities   | 0   | 83,903                                     | 0                                   | 83,903                 |
| Collateralized mortgage obligations,<br>Issued by U.S. Government agencies | 0   | 238,823                                    | 0                                   | 238,823                |
| Collateralized debt obligations  | 0   | 34   | 0                                   | 34                     |
| Total debt securities  | 0   | 508,153                                    | 0                                   | 508,153                |
| Marketable equity securities   | 8,654   | 0  | 0                                   | 8,654                  |
| Total available-for-sale securities  | 8,654   | 508,153                                    | 0                                   | 516,807                |
| Servicing rights   | 0   | 0  | 1,281                               | 1,281                  |
| Total recurring fair value measurements                                    | \$ 8,654  | \$ 508,153                                 | \$ 1,281                            | \$ 518,088             |
| Nonrecurring fair value measurements                                       |   |  |                                     |                        |
| Impaired loans with a valuation allowance                                  | \$ 0  | \$ 0                                       | \$ 3,241                            | \$ 3,241               |
| Valuation allowance  | 0   | 0  | (769                                | ) (769 )               |
| Impaired loans, net  | 0   | 0  | 2,472                               | 2,472                  |
| Foreclosed assets held for sale  | 0   | 0  | 1,189                               | 1,189                  |
| Total nonrecurring fair value measurements                                 | \$ 0  | \$ 0                                       | \$ 3,661                            | \$ 3,661               |

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

Management's evaluation and selection of valuation techniques and the unobservable inputs used in determining the fair values of assets valued using Level 3 methodologies include sensitive assumptions. Other market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amount calculated by management. The following table shows quantitative information regarding significant techniques and inputs used at December 31, 2015 and 2014 for servicing rights assets measured using unobservable inputs (Level 3 methodologies) on a recurring basis:



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

| Asset               | Fair Value at<br>12/31/14<br>(In<br>Thousands) | Valuation<br>Technique  | Unobservable<br>Input(s)                  | Method or Value As of<br>12/31/14               |  |
|---------------------|--|-------------------------|---|---|--|
| Servicing<br>rights | \$ 1,281                                       | Discounted<br>cash flow | Discount rate                             | 10.00 % Rate used through modeling period       |  |
|                     |  |                         | Loan prepayment<br>speeds                 | 156.00% 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<br>loan on loans more than 30 days<br>delinquent |
|                     |  |                         |   |   | 1.50 % of loans more than 30 days delinquent   |
|                     |  |                         | 3.00 % annual increase in servicing costs |   |  |

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

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

| (In Thousands)                         | Years Ended December 31, |           |
|--|--------------------------|-----------|
|  | 2015                     | 2014      |
|  | Servicing                | Servicing |
|  | Rights                   | Rights    |
| Balance, beginning of period           | \$ 1,281                 | \$ 1,123  |
| Issuances of servicing rights          | 177                      | 185       |
| Unrealized losses included in earnings | (162 )                   | (27 )     |
| Balance, end of period                 | \$ 1,296                 | \$ 1,281  |



| (In Thousands)  | Year Ended December 31, 2013                        |  |                  |         |
|---|---|--|------------------|---------|
|   | Pooled Trust Preferred Securities - Senior Tranches | Pooled Trust Preferred Securities - Mezzanine Tranches | Servicing Rights | Total   |
| Balance, beginning of period                            | \$1,613   | \$ 0   | \$ 605           | \$2,218 |
| Issuances of servicing rights                           | 0   | 0  | 451              | 451     |
| Accretion and amortization, net                         | (2 )  | 0  | 0                | (2 )    |
| Proceeds from sales and calls                           | (1,636)   | (571 )   | 0                | (2,207) |
| Realized gains, net                                     | 23  | 571  | 0                | 594     |
| Unrealized gains included in earnings                   | 0   | 0  | 67               | 67      |
| Unrealized gains included in other comprehensive income | 2   | 0  | 0                | 2       |
| Balance, end of period                                  | \$0   | \$ 0   | \$ 1,123         | \$1,123 |

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

At December 31, 2015 and 2014, 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)       | Balance at 12/31/15 | Valuation Allowance at 12/31/15 | Fair Value at 12/31/15 | Valuation Technique | Unobservable Inputs         | Value at 12/31/15 (Weighted Average) |
|--|---------------------|---------------------------------|------------------------|---------------------|-----------------------------|--------------------------------------|
| Impaired loans:                          |                     |                                 |                        |                     |                             |                                      |
| Residential mortgage loans - first liens | \$ 42               | \$ 1                            | \$ 41                  | Sales comparison    | Discount to appraised value | 31 %                                 |
| Commercial:                              |                     |                                 |                        |                     |                             |                                      |
| Commercial loans secured by real estate  | 317                 | 97                              | 220                    | Sales comparison    | Discount to appraised value | 46 %                                 |
| Commercial and industrial                | 75                  | 75                              | 0                      |                     |                             | 31 %                                 |

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|  |          |        |          |                  |                             |    |   |
|--|----------|--------|----------|------------------|-----------------------------|----|---|
|  |          |        |          | Sales comparison | Discount to appraised value |    |   |
| Loans secured by farmland                      | 512      | 52     | 460      | Sales comparison | Discount to appraised value | 49 | % |
| Multi-family (5 or more) residential           | 987      | 595    | 392      | Sales comparison | Discount to appraised value | 41 | % |
| Total impaired loans                           | \$ 1,933 | \$ 820 | \$ 1,113 |                  |                             |    |   |
| Foreclosed assets held for sale - real estate: |          |        |          |                  |                             |    |   |
| Residential (1-4 family)                       | \$ 556   | \$ 0   | \$ 556   | Sales comparison | Discount to appraised value | 32 | % |
| Land   | 704      | 0      | 704      | Sales comparison | Discount to appraised value | 29 | % |
| Total foreclosed assets held for sale          | \$ 1,260 | \$ 0   | \$ 1,260 |                  |                             |    |   |

| (In Thousands, Except Percentages)             | Balance at 12/31/14 | Valuation Allowance at 12/31/14 | Fair Value at 12/31/14 | Valuation Technique | Unobservable Inputs         | Value at 12/31/14 (Weighted Average) |
|--|---------------------|---------------------------------|------------------------|---------------------|-----------------------------|--------------------------------------|
| Asset  |                     |                                 |                        |                     |                             |                                      |
| Impaired loans:                                |                     |                                 |                        |                     |                             |                                      |
| Residential mortgage loans - first liens       | \$ 715              | \$ 358                          | \$ 357                 | Sales comparison    | Discount to appraised value | 36 %                                 |
| Commercial:                                    |                     |                                 |                        |                     |                             |                                      |
| Commercial loans secured by real estate        | 16                  | 16                              | 0                      | Sales comparison    | Discount to appraised value | 42 %                                 |
| Commercial and industrial                      | 150                 | 82                              | 68                     | Sales comparison    | Discount to appraised value | 21 %                                 |
| Commercial construction and land               | 1,815               | 211                             | 1,604                  | Sales comparison    | Discount to appraised value | 30 %                                 |
| Loans secured by farmland                      | 545                 | 102                             | 443                    | Sales comparison    | Discount to appraised value | 40 %                                 |
| Total impaired loans                           | \$ 3,241            | \$ 769                          | \$ 2,472               |                     |                             |                                      |
| Foreclosed assets held for sale - real estate: |                     |                                 |                        |                     |                             |                                      |
| Residential (1-4 family)                       | \$ 306              | \$ 0                            | \$ 306                 | Sales comparison    | Discount to appraised value | 42 %                                 |
| Commercial property                            | 159                 | 0                               | 159                    | Sales comparison    | Discount to appraised value | 23 %                                 |
| Land   | 724                 | 0                               | 724                    | Sales comparison    | Discount to appraised value | 29 %                                 |
| Total foreclosed assets held for sale          | \$ 1,189            | \$ 0                            | \$ 1,189               |                     |                             |                                      |

No other-than-temporary impairment losses on securities valued using Level 3 methodologies were recorded in 2015, 2014 or 2013.

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

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

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

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

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

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

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

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

**DEPOSITS** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable at December 31, 2015 and 2014. The fair value of time deposits, such as certificates of deposit and Individual Retirement Accounts, is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates of deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.



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

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

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

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

| (In Thousands)  | Valuation Method(s) Used | December 31, 2015 |            | December 31, 2014 |            |
|---|--------------------------|-------------------|------------|-------------------|------------|
|   |                          | Carrying Amount   | Fair Value | Carrying Amount   | Fair Value |
| Financial assets:                                       |                          |                   |            |                   |            |
| Cash and cash equivalents                               | Level 1                  | \$33,313          | \$33,313   | \$31,619          | \$31,619   |
| Certificates of deposit                                 | Level 2                  | 2,748             | 2,752      | 4,428             | 4,443      |
| Available-for-sale securities                           | See Above                | 420,290           | 420,290    | 516,807           | 516,807    |
| Restricted equity securities (included in Other Assets) | Level 2                  | 4,657             | 4,657      | 1,584             | 1,584      |
| Loans held for sale                                     | Level 2                  | 280               | 280        | 0                 | 0          |
| Loans, net  | Level 3                  | 696,991           | 685,552    | 623,209           | 629,267    |
| Accrued interest receivable                             | Level 2                  | 3,768             | 3,768      | 3,908             | 3,908      |
| Servicing rights  | Level 3                  | 1,296             | 1,296      | 1,281             | 1,281      |
| Financial liabilities:                                  |                          |                   |            |                   |            |
| Deposits with no stated maturity                        | Level 2                  | 713,931           | 713,931    | 729,052           | 729,052    |
| Time deposits   | Level 2                  | 221,684           | 221,891    | 238,937           | 239,712    |
| Short-term borrowings                                   | Level 2                  | 53,496            | 53,398     | 5,537             | 5,473      |
| Long-term borrowings                                    | Level 2                  | 38,767            | 40,166     | 73,060            | 78,866     |
| Accrued interest payable                                | Level 2                  | 70                | 70         | 104               | 104        |

**7. SECURITIES**

Amortized cost and fair value of available-for-sale securities at December 31, 2015 and 2014 are summarized as follows:

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

| (In Thousands)  | Amortized<br>Cost | December 31, 2014                       |  | Fair<br>Value |
|---|-------------------|---|--|---------------|
|   |                   | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |               |
| Obligations of U.S. Government agencies                                 | \$ 27,221         | \$ 38                                   | \$ (583)                                 | ) \$ 26,676   |
| Obligations of states and political subdivisions:                       |                   |   |  |               |
| Tax-exempt  | 120,086           | 5,134                                   | (381)                                    | ) 124,839     |
| Taxable   | 33,637            | 415                                     | (174)                                    | ) 33,878      |
| Mortgage-backed securities  | 82,479            | 1,493                                   | (69)                                     | ) 83,903      |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 239,620           | 1,239                                   | (2,036)                                  | ) 238,823     |
| Collateralized debt obligations:  | 34                | 0                                       | 0  | ) 34          |
| Total debt securities   | 503,077           | 8,319                                   | (3,243)                                  | ) 508,153     |
| Marketable equity securities  | 5,605             | 3,058                                   | (9)                                      | ) 8,654       |
| Total   | \$ 508,682        | \$ 11,377                               | \$ (3,252)                               | ) \$ 516,807  |

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The following table presents gross unrealized losses and fair value of available-for-sale securities with unrealized loss positions that are not deemed to be other-than-temporarily impaired, aggregated by length of time that individual securities have been in a continuous unrealized loss position at December 31, 2015 and 2014:

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



| December 31, 2014<br>(In Thousands)                                     | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Obligations of U.S. Government agencies                                 | \$ 0                | \$ 0              | \$24,020          | \$ (583)          | \$24,020   | \$ (583)          |
| Obligations of states and political subdivisions:                       |                     |                   |                   |                   |            |                   |
| Tax-exempt  | 11,898              | (289)             | 6,991             | (92)              | 18,889     | (381)             |
| Taxable   | 4,240               | (22)              | 9,159             | (152)             | 13,399     | (174)             |
| Mortgage-backed securities  | 0                   | 0                 | 4,160             | (69)              | 4,160      | (69)              |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 58,812              | (396)             | 60,897            | (1,640)           | 119,709    | (2,036)           |
| Total debt securities   | 74,950              | (707)             | 105,227           | (2,536)           | 180,177    | (3,243)           |
| Marketable equity securities  | 134                 | (9)               | 0                 | 0                 | 134        | (9)               |
| Total temporarily impaired available-for-sale securities                | \$ 75,084           | \$ (716)          | \$ 105,227        | \$ (2,536)        | \$ 180,311 | \$ (3,252)        |

Gross realized gains and losses from available-for-sale securities (including OTTI losses in gross realized losses) and the related income tax provision were as follows:

| (In Thousands)                                     | 2015    | 2014    | 2013    |
|--|---------|---------|---------|
| Gross realized gains from sales                    | \$2,972 | \$1,328 | \$1,918 |
| Gross realized losses from sales                   | (111)   | (224)   | (175)   |
| Losses from OTTI Impairment                        | 0       | 0       | (25)    |
| Net realized gains                                 | \$2,861 | \$1,104 | \$1,718 |
| Income tax provision related to net realized gains | \$1,002 | \$386   | \$601   |

The amortized cost and fair value of available-for-sale debt securities by contractual maturity are shown in the following table as of December 31, 2015. Actual maturities may differ from contractual maturities because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands)                        | Amortized Cost | Fair Value |
|---------------------------------------|----------------|------------|
| Due in one year or less               | \$9,087        | \$9,154    |
| Due from one year through five years  | 60,639         | 61,664     |
| Due from five years through ten years | 45,173         | 46,227     |
| Due after ten years                   | 33,504         | 35,801     |
| Subtotal                              | 148,403        | 152,846    |
| Mortgage-backed securities            | 73,227         | 73,343     |

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|   |            |            |
|---|------------|------------|
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 193,145    | 191,715    |
| Total   | \$ 414,775 | \$ 417,904 |

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

Investment securities carried at \$228,616,000 at December 31, 2015 and \$369,945,000 at December 31, 2014 were pledged as collateral for public deposits, trusts and certain other deposits as provided by law. See Note 12 for information concerning securities pledged to secure borrowing arrangements.

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

The Corporation recognized net impairment losses in earnings, as follows:

(In Thousands)

|  | 2015 | 2014 | 2013   |
|--|------|------|--------|
| Marketable equity securities (bank stocks) | \$ 0 | \$ 0 | \$(25) |

A summary of information management considered in evaluating debt and equity securities for OTTI at December 31, 2015 is provided below.

### **Debt Securities**

At December 31, 2015 and 2014, management performed an assessment for possible OTTI of the Corporation's debt securities on an issue-by-issue basis, relying on information obtained from various sources, including publicly available financial data, ratings by external agencies, brokers and other sources. The extent of individual analysis applied to each security depended on the size of the Corporation's investment, as well as management's perception of the credit risk associated with each security. Based on the results of the assessment, management believes impairment of these debt securities, including municipal bonds with no external ratings, at December 31, 2015 to be temporary.

### **Equity Securities**

The Corporation's marketable equity securities at December 31, 2015 and 2014 consisted exclusively of stocks of banking companies. The Corporation recognized no other-than-temporary impairment losses related to bank stocks in 2015 or 2014. In 2013, the Corporation recognized an other-than-temporary impairment loss related to a bank stock of \$25,000. Management evaluates recognition of other-than-temporary impairment losses based on review of the issuers' published financial results to determine if recovery of the Corporation's cost basis within the foreseeable future is uncertain. At December 31, 2015, the Corporation held no stocks with an unrealized loss.

Realized gains from sales of bank stocks totaled \$2,220,000 in 2015, \$363,000 in 2014, and \$1,018,000 in 2013.

C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 11 regional Federal Home Loan Banks. As a member, C&N Bank is required to purchase and maintain stock in FHLB-Pittsburgh. There is no active market for FHLB-Pittsburgh stock, and it must ordinarily be redeemed by

FHLB-Pittsburgh in order to be liquidated. C&N Bank's investment in FHLB-Pittsburgh stock, included in Other Assets in the consolidated balance sheet, was \$4,527,000 at December 31, 2015 and \$1,454,000 at December 31, 2014. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at December 31, 2015 and December 31, 2014. 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.

**8. LOANS**

Loans outstanding at December 31, 2015 and 2014 are summarized as follows:

| Summary of Loans by Type<br>(In Thousands) | Dec. 31,<br>2015 | Dec. 31,<br>2014 |
|--|------------------|------------------|
| Residential mortgage:                      |                  |                  |
| Residential mortgage loans - first liens   | \$304,783        | \$291,882        |
| Residential mortgage loans - junior liens  | 21,146           | 21,166           |
| Home equity lines of credit                | 39,040           | 36,629           |
| 1-4 Family residential construction        | 21,121           | 16,739           |
| Total residential mortgage                 | 386,090          | 366,416          |
| Commercial:                                |                  |                  |
| Commercial loans secured by real estate    | 154,779          | 145,878          |
| Commercial and industrial                  | 75,196           | 50,157           |
| Political subdivisions                     | 40,007           | 17,534           |
| Commercial construction and land           | 5,122            | 6,938            |
| Loans secured by farmland                  | 7,019            | 7,916            |
| Multi-family (5 or more) residential       | 9,188            | 8,917            |
| Agricultural loans                         | 4,671            | 3,221            |
| Other commercial loans                     | 12,152           | 13,334           |
| Total commercial                           | 308,134          | 253,895          |
| Consumer                                   | 10,656           | 10,234           |
| Total                                      | 704,880          | 630,545          |
| Less: allowance for loan losses            | (7,889 )         | (7,336 )         |
| Loans, net                                 | \$696,991        | \$623,209        |

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 make up 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 December 31, 2015.

Transactions within the allowance for loan losses, summarized by segment and class, were as follows:

| Year Ended December 31, 2015<br>(In Thousands) | Dec. 31,<br>2014<br>Balance | Charge-offs      | Recoveries    | Provision<br>(Credit) | Dec. 31,<br>2015<br>Balance |
|--|-----------------------------|------------------|---------------|-----------------------|-----------------------------|
| Allowance for Loan Losses:                     |                             |                  |               |                       |                             |
| Residential mortgage:                          |                             |                  |               |                       |                             |
| Residential mortgage loans - first liens       | \$ 2,941                    | \$ (175 )        | \$ 1          | \$ (122 )             | \$ 2,645                    |
| Residential mortgage loans - junior liens      | 176                         | (42 )            | 0             | 85                    | 219                         |
| Home equity lines of credit                    | 322                         | 0                | 0             | 25                    | 347                         |
| 1-4 Family residential construction            | 214                         | 0                | 0             | (7 )                  | 207                         |
| Total residential mortgage                     | 3,653                       | (217 )           | 1             | (19 )                 | 3,418                       |
| Commercial:                                    |                             |                  |               |                       |                             |
| Commercial loans secured by real estate        | 1,758                       | (115 )           | 208           | 88                    | 1,939                       |
| Commercial and industrial                      | 688                         | (21 )            | 6             | 308                   | 981                         |
| Political subdivisions                         | 0                           | 0                | 0             | 0                     | 0                           |
| Commercial construction and land               | 283                         | (115 )           | 0             | (110 )                | 58                          |
| Loans secured by farmland                      | 165                         | 0                | 0             | (59 )                 | 106                         |
| Multi-family (5 or more) residential           | 87                          | 0                | 0             | 588                   | 675                         |
| Agricultural loans                             | 31                          | 0                | 0             | 14                    | 45                          |
| Other commercial loans                         | 131                         | 0                | 0             | (13 )                 | 118                         |
| Total commercial                               | 3,143                       | (251 )           | 214           | 816                   | 3,922                       |
| Consumer                                       | 145                         | (94 )            | 55            | 16                    | 122                         |
| Unallocated                                    | 395                         | 0                | 0             | 32                    | 427                         |
| <b>Total Allowance for Loan Losses</b>         | <b>\$ 7,336</b>             | <b>\$ (562 )</b> | <b>\$ 270</b> | <b>\$ 845</b>         | <b>\$ 7,889</b>             |

| Year Ended December 31, 2014<br>(In Thousands) | Dec. 31,<br>2013<br>Balance | Charge-offs | Recoveries | Provision<br>(Credit) | Dec. 31,<br>2014<br>Balance |
|--|-----------------------------|-------------|------------|-----------------------|-----------------------------|
| Allowance for Loan Losses:                     |                             |             |            |                       |                             |
| Residential mortgage:                          |                             |             |            |                       |                             |
| Residential mortgage loans - first liens       | \$ 2,974                    | \$ (164 )   | \$ 25      | \$ 106                | \$ 2,941                    |
| Residential mortgage loans - junior liens      | 294                         | (101 )      | 0          | (17 )                 | \$ 176                      |
| Home equity lines of credit                    | 269                         | (62 )       | 0          | 115                   | \$ 322                      |
| 1-4 Family residential construction            | 168                         | 0           | 0          | 46                    | \$ 214                      |
| Total residential mortgage                     | 3,705                       | (327 )      | 25         | 250                   | 3,653                       |
| Commercial:                                    |                             |             |            |                       |                             |
| Commercial loans secured by real estate        | 3,123                       | (1,521 )    | 250        | (94 )                 | 1,758                       |
| Commercial and industrial                      | 591                         | (24 )       | 9          | 112                   | 688                         |
| Political subdivisions                         | 0                           | 0           | 0          | 0                     | 0                           |
| Commercial construction and land               | 267                         | (170 )      | 5          | 181                   | 283                         |
| Loans secured by farmland                      | 115                         | 0           | 0          | 50                    | 165                         |

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|                                      |          |             |        |        |          |
|--------------------------------------|----------|-------------|--------|--------|----------|
| Multi-family (5 or more) residential | 103      | 0           | 0      | (16 )  | 87       |
| Agricultural loans                   | 30       | 0           | 0      | 1      | 31       |
| Other commercial loans               | 138      | 0           | 0      | (7 )   | 131      |
| Total commercial                     | 4,367    | (1,715 )    | 264    | 227    | 3,143    |
| Consumer                             | 193      | (97 )       | 47     | 2      | 145      |
| Unallocated                          | 398      | 0           | 0      | (3 )   | 395      |
| Total Allowance for Loan Losses      | \$ 8,663 | \$ (2,139 ) | \$ 336 | \$ 476 | \$ 7,336 |

Year Ended December 31, 2013

(In Thousands)

|   | Dec. 31,<br>2012 |                  |               | Provision       | Dec. 31,<br>2013 |
|---|------------------|------------------|---------------|-----------------|------------------|
|   | Balance          | Charge-offs      | Recoveries    | (Credit)        | Balance          |
| Allowance for Loan Losses:                |                  |                  |               |                 |                  |
| Residential mortgage:                     |                  |                  |               |                 |                  |
| Residential mortgage loans - first liens  | \$ 2,619         | \$ (84 )         | \$ 24         | \$ 415          | \$ 2,974         |
| Residential mortgage loans - junior liens | 247              | 0                | 0             | 47              | 294              |
| Home equity lines of credit               | 255              | 0                | 0             | 14              | 269              |
| 1-4 Family residential construction       | 96               | (11 )            | 0             | 83              | 168              |
| Total residential mortgage                | 3,217            | (95 )            | 24            | 559             | 3,705            |
| Commercial:                               |                  |                  |               |                 |                  |
| Commercial loans secured by real estate   | 1,930            | (169 )           | 344           | 1,018           | 3,123            |
| Commercial and industrial                 | 581              | (286 )           | 4             | 292             | 591              |
| Political subdivisions                    | 0                | 0                | 0             | 0               | 0                |
| Commercial construction and land          | 234              | (4 )             | 0             | 37              | 267              |
| Loans secured by farmland                 | 129              | 0                | 0             | (14 )           | 115              |
| Multi-family (5 or more) residential      | 67               | 0                | 0             | 36              | 103              |
| Agricultural loans                        | 27               | 0                | 0             | 3               | 30               |
| Other commercial loans                    | 3                | 0                | 0             | 135             | 138              |
| Total commercial                          | 2,971            | (459 )           | 348           | 1,507           | 4,367            |
| Consumer                                  | 228              | (117 )           | 58            | 24              | 193              |
| Unallocated                               | 441              | 0                | 0             | (43 )           | 398              |
| <b>Total Allowance for Loan Losses</b>    | <b>\$ 6,857</b>  | <b>\$ (671 )</b> | <b>\$ 430</b> | <b>\$ 2,047</b> | <b>\$ 8,663</b>  |

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.

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





The following tables summarize the aggregate credit quality classification of outstanding loans by risk rating as of December 31, 2015 and 2014:

December 31, 2015

(In Thousands)

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

December 31, 2014

(In Thousands)

|   | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| Residential Mortgage:                     |           |                    |             |          |           |
| Residential mortgage loans - first liens  | \$280,094 | \$1,246            | \$ 10,464   | \$ 78    | \$291,882 |
| Residential mortgage loans - junior liens | 20,502    | 112                | 552         | 0        | 21,166    |
| Home equity lines of credit               | 35,935    | 294                | 400         | 0        | 36,629    |
| 1-4 Family residential construction       | 16,719    | 20                 | 0           | 0        | 16,739    |
| Total residential mortgage                | 353,250   | 1,672              | 11,416      | 78       | 366,416   |
| Commercial:                               |           |                    |             |          |           |
| Commercial loans secured by real estate   | 133,204   | 2,775              | 9,899       | 0        | 145,878   |
| Commercial and Industrial                 | 41,751    | 7,246              | 1,042       | 118      | 50,157    |
| Political subdivisions                    | 17,534    | 0                  | 0           | 0        | 17,534    |
| Commercial construction and land          | 4,650     | 266                | 2,022       | 0        | 6,938     |
| Loans secured by farmland                 | 5,990     | 433                | 1,468       | 25       | 7,916     |
| Multi-family (5 or more) residential      | 8,629     | 288                | 0           | 0        | 8,917     |
| Agricultural loans                        | 3,196     | 0                  | 25          | 0        | 3,221     |
| Other commercial loans                    | 13,248    | 86                 | 0           | 0        | 13,334    |
| Total commercial                          | 228,202   | 11,094             | 14,456      | 143      | 253,895   |

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|          |           |          |          |       |           |
|----------|-----------|----------|----------|-------|-----------|
| Consumer | 10,095    | 22       | 117      | 0     | 10,234    |
| Totals   | \$591,547 | \$12,788 | \$25,989 | \$221 | \$630,545 |

The scope of loans evaluated individually for impairment include all loan relationships greater than \$200,000 for which there is at least one extension of credit graded Special Mention, Substandard or Doubtful. Also, all loans classified as troubled debt restructurings (discussed in more detail below) and all loan relationships less than \$200,000 in the aggregate, but with an estimated loss of \$100,000 or more, are individually evaluated for impairment. Loans that are individually evaluated for impairment, but which are not determined to be impaired, are combined with all remaining loans that are not reviewed on a specific basis, and such loans are included within larger pools of loans based on similar risk and loss characteristics for purposes of determining the general component of the allowance. The loans that have been individually evaluated, but which have not been determined to be impaired, are included in the “Collectively Evaluated” column in the table summarizing the allowance and associated loan balances as of December 31, 2015 and 2014.

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 December 31, 2015 and 2014:

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

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| December 31, 2014<br>(In Thousands)       | Loans:           |                   |                   | Allowance for Loan Losses: |                 |                 |
|---|------------------|-------------------|-------------------|----------------------------|-----------------|-----------------|
|   | Individual       | Collectively      | Totals            | Individual                 | Collectively    | Totals          |
|   | Evaluated        | Evaluated         |                   | Evaluated                  | Evaluated       |                 |
| <b>Residential mortgage:</b>              |                  |                   |                   |                            |                 |                 |
| Residential mortgage loans - first liens  | \$ 1,665         | \$ 290,217        | \$ 291,882        | \$ 358                     | \$ 2,583        | \$ 2,941        |
| Residential mortgage loans - junior liens | 17               | 21,149            | 21,166            | 0                          | 176             | 176             |
| Home equity lines of credit               | 0                | 36,629            | 36,629            | 0                          | 322             | 322             |
| 1-4 Family residential construction       | 0                | 16,739            | 16,739            | 0                          | 214             | 214             |
| Total residential mortgage                | 1,682            | 364,734           | 366,416           | 358                        | 3,295           | 3,653           |
| <b>Commercial:</b>                        |                  |                   |                   |                            |                 |                 |
| Commercial loans secured by real estate   | 6,537            | 139,341           | 145,878           | 16                         | 1,742           | 1,758           |
| Commercial and industrial                 | 663              | 49,494            | 50,157            | 82                         | 606             | 688             |
| Political subdivisions                    | 0                | 17,534            | 17,534            | 0                          | 0               | 0               |
| Commercial construction and land          | 1,939            | 4,999             | 6,938             | 211                        | 72              | 283             |
| Loans secured by farmland                 | 1,470            | 6,446             | 7,916             | 102                        | 63              | 165             |
| Multi-family (5 or more) residential      | 0                | 8,917             | 8,917             | 0                          | 87              | 87              |
| Agricultural loans                        | 25               | 3,196             | 3,221             | 0                          | 31              | 31              |
| Other commercial loans                    | 0                | 13,334            | 13,334            | 0                          | 131             | 131             |
| Total commercial                          | 10,634           | 243,261           | 253,895           | 411                        | 2,732           | 3,143           |
| Consumer                                  | 0                | 10,234            | 10,234            | 0                          | 145             | 145             |
| Unallocated                               |                  |                   |                   |                            |                 | 395             |
| <b>Total</b>                              | <b>\$ 12,316</b> | <b>\$ 618,229</b> | <b>\$ 630,545</b> | <b>\$ 769</b>              | <b>\$ 6,172</b> | <b>\$ 7,336</b> |

Summary information related to impaired loans as of December 31, 2015 and 2014 is as follows:

| (In Thousands)                             | December 31, 2015              |                        |                      | December 31, 2014              |                        |                      |
|--|--------------------------------|------------------------|----------------------|--------------------------------|------------------------|----------------------|
|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance |
| <b>With no related allowance recorded:</b> |                                |                        |                      |                                |                        |                      |
| Residential mortgage loans - first liens   | \$ 842                         | \$ 842                 | \$ 0                 | \$ 950                         | \$ 950                 | \$ 0                 |
| Residential mortgage loans - junior liens  | 74                             | 74                     | 0                    | 17                             | 17                     | 0                    |
| Commercial loans secured by real estate    | 7,580                          | 5,945                  | 0                    | 8,062                          | 6,521                  | 0                    |
| Commercial and industrial                  | 249                            | 249                    | 0                    | 513                            | 513                    | 0                    |
| Commercial construction and land           | 0                              | 0                      | 0                    | 124                            | 124                    | 0                    |
| Loans secured by farmland                  | 915                            | 915                    | 0                    | 925                            | 925                    | 0                    |
| Agricultural loans                         | 16                             | 16                     | 0                    | 25                             | 25                     | 0                    |
| Total with no related allowance recorded   | 9,676                          | 8,041                  | 0                    | 10,616                         | 9,075                  | 0                    |
| <b>With a related allowance recorded:</b>  |                                |                        |                      |                                |                        |                      |
| Residential mortgage loans - first liens   | 42                             | 42                     | 1                    | 715                            | 715                    | 358                  |
| Commercial loans secured by real estate    | 317                            | 317                    | 97                   | 16                             | 16                     | 16                   |

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|   |          |          |        |          |           |        |
|---|----------|----------|--------|----------|-----------|--------|
| Commercial and industrial               | 75       | 75       | 75     | 150      | 150       | 82     |
| Commercial construction and land        | 0        | 0        | 0      | 1,815    | 1,815     | 211    |
| Loans secured by farmland               | 512      | 512      | 52     | 545      | 545       | 102    |
| Multi-family (5 or more) residential    | 987      | 987      | 595    | 0        | 0         | 0      |
| Total with a related allowance recorded | 1,933    | 1,933    | 820    | 3,241    | 3,241     | 769    |
| Total                                   | \$11,609 | \$ 9,974 | \$ 820 | \$13,857 | \$ 12,316 | \$ 769 |

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

| (In Thousands)                           | Average Investment in Impaired Loans<br>Year Ended December 31, |           |          | Interest Income Recognized on<br>Impaired Loans on a Cash Basis<br>Year Ended December 31, |        |        |
|--|---|-----------|----------|--|--------|--------|
|  | 2015  | 2014      | 2013     | 2015   | 2014   | 2013   |
| <b>Residential mortgage:</b>             |   |           |          |  |        |        |
| Residential mortgage loans - first lien  | \$ 2,206  | \$ 4,272  | \$ 3,334 | \$ 86  | \$ 81  | \$ 199 |
| Residential mortgage loans - junior lien | 64  | 168       | 245      | 4  | 3      | 17     |
| Total residential mortgage               | 2,270   | 4,440     | 3,579    | 90   | 84     | 216    |
| <b>Commercial:</b>                       |   |           |          |  |        |        |
| Commercial loans secured by real estate  | 6,357   | 7,192     | 2,931    | 380  | 469    | 90     |
| Commercial and industrial                | 438   | 877       | 941      | 20   | 37     | 35     |
| Commercial construction and land         | 40  | 395       | 999      | 0  | 9      | 14     |
| Loans secured by farmland                | 1,459   | 1,413     | 1,171    | 103  | 101    | 66     |
| Multi-family (5 or more) residential     | 790   | 0         | 22       | 0  | 0      | 2      |
| Agricultural loans                       | 21  | 41        | 43       | 3  | 3      | 3      |
| Total commercial                         | 9,105   | 9,918     | 6,107    | 506  | 619    | 210    |
| Consumer                                 | 0   | 1         | 4        | 0  | 0      | 0      |
| Total                                    | \$ 11,375   | \$ 14,359 | \$ 9,690 | \$ 596   | \$ 703 | \$ 426 |

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

| (In Thousands)                            | December 31, 2015              |            | December 31, 2014              |            |
|---|--------------------------------|------------|--------------------------------|------------|
|   | Past Due 90+ Days and Accruing | Nonaccrual | Past Due 90+ Days and Accruing | Nonaccrual |
| <b>Residential mortgage:</b>              |                                |            |                                |            |
| Residential mortgage loans - first liens  | \$ 2,381                       | \$ 3,044   | \$ 1,989                       | \$ 3,440   |
| Residential mortgage loans - junior liens | 79                             | 0          | 82                             | 50         |
| Home equity lines of credit               | 130                            | 0          | 49                             | 22         |
| Total residential mortgage                | 2,590                          | 3,044      | 2,120                          | 3,512      |
| <b>Commercial:</b>                        |                                |            |                                |            |
| Commercial loans secured by real estate   | 503                            | 5,730      | 653                            | 5,804      |
| Commercial and industrial                 | 65                             | 313        | 5                              | 379        |
| Commercial construction and land          | 0                              | 0          | 35                             | 1,915      |
| Loans secured by farmland                 | 0                              | 1,427      | 0                              | 951        |
| Multi-family (5 or more) residential      | 0                              | 987        | 0                              | 0          |

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|                    |          |           |          |           |
|--------------------|----------|-----------|----------|-----------|
| Agricultural loans | 0        | 16        | 0        | 25        |
| Total commercial   | 568      | 8,473     | 693      | 9,074     |
| Consumer           | 71       | 0         | 30       | 24        |
| Totals             | \$ 3,229 | \$ 11,517 | \$ 2,843 | \$ 12,610 |

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



The tables below present a summary of the contractual aging of loans as of December 31, 2015 and 2014:

| (In Thousands)                            | As of December 31, 2015 |                 |                 |                  | As of December 31, 2014 |                 |                 |                  |
|---|-------------------------|-----------------|-----------------|------------------|-------------------------|-----------------|-----------------|------------------|
|   | Current &               |                 |                 | Total            | Current &               |                 |                 | Total            |
|   | Past Due                | Past Due        | Past Due        |                  | Past Due                | Past Due        | Past Due        |                  |
|   | Less than 30 Days       | 30-89 Days      | 90+ Days        |                  | Less than 30 Days       | 30-89 Days      | 90+ Days        |                  |
| <b>Residential mortgage:</b>              |                         |                 |                 |                  |                         |                 |                 |                  |
| Residential mortgage loans - first liens  | \$294,703               | \$ 6,156        | \$ 3,924        | \$304,783        | \$282,766               | \$ 5,443        | \$ 3,673        | \$291,882        |
| Residential mortgage loans - junior liens | 20,816                  | 251             | 79              | 21,146           | 20,853                  | 190             | 123             | 21,166           |
| Home equity lines of credit               | 38,581                  | 329             | 130             | 39,040           | 36,300                  | 258             | 71              | 36,629           |
| 1-4 Family residential construction       | 21,121                  | 0               | 0               | 21,121           | 16,739                  | 0               | 0               | 16,739           |
| <b>Total residential mortgage</b>         | <b>375,221</b>          | <b>6,736</b>    | <b>4,133</b>    | <b>386,090</b>   | <b>356,658</b>          | <b>5,891</b>    | <b>3,867</b>    | <b>366,416</b>   |
| <b>Commercial:</b>                        |                         |                 |                 |                  |                         |                 |                 |                  |
| Commercial loans secured by real estate   | 153,427                 | 108             | 1,244           | 154,779          | 143,713                 | 883             | 1,282           | 145,878          |
| Commercial and industrial                 | 75,002                  | 118             | 76              | 75,196           | 49,994                  | 43              | 120             | 50,157           |
| Political subdivisions                    | 40,007                  | 0               | 0               | 40,007           | 17,534                  | 0               | 0               | 17,534           |
| Commercial construction and land          | 5,018                   | 104             | 0               | 5,122            | 4,897                   | 91              | 1,950           | 6,938            |
| Loans secured by farmland                 | 5,970                   | 223             | 826             | 7,019            | 6,811                   | 254             | 851             | 7,916            |
| Multi-family (5 or more) residential      | 8,201                   | 0               | 987             | 9,188            | 8,720                   | 197             | 0               | 8,917            |
| Agricultural loans                        | 4,642                   | 13              | 16              | 4,671            | 3,105                   | 91              | 25              | 3,221            |
| Other commercial loans                    | 12,152                  | 0               | 0               | 12,152           | 13,334                  | 0               | 0               | 13,334           |
| <b>Total commercial</b>                   | <b>304,419</b>          | <b>566</b>      | <b>3,149</b>    | <b>308,134</b>   | <b>248,108</b>          | <b>1,559</b>    | <b>4,228</b>    | <b>253,895</b>   |
| Consumer                                  | 10,537                  | 48              | 71              | 10,656           | 10,164                  | 40              | 30              | 10,234           |
| <b>Totals</b>                             | <b>\$690,177</b>        | <b>\$ 7,350</b> | <b>\$ 7,353</b> | <b>\$704,880</b> | <b>\$614,930</b>        | <b>\$ 7,490</b> | <b>\$ 8,125</b> | <b>\$630,545</b> |

Nonaccrual loans are included in the contractual aging immediately above. A summary of the contractual aging of nonaccrual loans at December 31, 2015 and 2014 is as follows:

| (In Thousands) | Current & |          |          |
|----------------|-----------|----------|----------|
|                | Past Due  | Past Due | Past Due |

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|                                     | Less than<br>30 Days | 30-89<br>Days | 90+<br>Days | Total    |
|-------------------------------------|----------------------|---------------|-------------|----------|
| December 31, 2015 Nonaccrual Totals | \$ 7,100             | \$ 293        | \$ 4,124    | \$11,517 |
| December 31, 2014 Nonaccrual Totals | \$ 6,959             | \$ 369        | \$ 5,282    | \$12,610 |

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 the contractual aging information at December 31, 2015 and 2014 is as follows:

**Troubled Debt Restructurings (TDRs):**

| (In Thousands)           | Current &<br>Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days | Nonaccrual | Total   |
|--------------------------|---|---------------------------|-------------------------|------------|---------|
| December 31, 2015 Totals | \$ 1,186                                      | \$ 0                      | \$ 81                   | \$ 5,097   | \$6,364 |
| December 31, 2014 Totals | \$ 1,725                                      | \$ 82                     | \$ 0                    | \$ 5,388   | \$7,195 |

A summary of TDRs that occurred during 2015, 2014 and 2013 is as follows:

| Year Ended December 31, 2015<br>(Balances in Thousands) | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|---|---------------------------|---|--|
| Residential mortgage:                                   |                           |   |  |
| Residential mortgage loans - first liens                | 2                         | \$ 298  | \$ 298   |
| Residential mortgage loans - junior liens               | 1                         | 32  | 32   |
| Consumer  | 1                         | 30  | 30   |

| Year Ended December 31, 2014<br>(Balances in Thousands) | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|---|---------------------------|---|--|
| Residential mortgage,                                   |                           |   |  |
| Residential mortgage loans - first liens                | 3                         | \$ 150  | \$ 150   |
| Commercial:   |                           |   |  |
| Commercial loans secured by real estate                 | 5                         | 6,679   | 5,193  |
| Commercial and industrial                               | 1                         | 80  | 80   |

| Year Ended December 31, 2013<br>(Balances in Thousands) | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|---|---------------------------|---|--|
| Residential mortgage:                                   |                           |   |  |
| Residential mortgage loans - first liens                | 6                         | \$ 677  | \$ 677   |
| Residential mortgage loans - junior liens               | 3                         | 102   | 102  |
| Commercial:   |                           |   |  |
| Commercial loans secured by real estate                 | 2                         | 866   | 866  |
| Commercial and industrial                               | 3                         | 701   | 701  |
| Loans secured by farmland                               | 4                         | 512   | 512  |
| Agricultural loans                                      | 1                         | 13  | 13   |
| Consumer  | 1                         | 6   | 6  |

The TDRs that occurred in 2015 related to residential mortgage loans – first liens that included an extended maturity date and a reduction in interest rate on one contract and a reduced payment amount on one contract. The TDR related to a residential mortgage – junior lien included a lowered interest rate and reduced payment amount. The TDR related to the consumer loan included a lowered interest rate and reduced payment amount. There was no allowance for loan

losses on these loans at December 31, 2015, and no change in the allowance for loan losses resulting from these TDRs.

The TDRs that occurred in 2014 related to residential mortgage loans that included a reduction in payment amount on one contract, an interest only period on one contract and a reduction in interest rate and payment on one contract. The TDRs related to commercial loans in the period ended December 31, 2014 relate to six contracts associated with one relationship. The Corporation entered into a forbearance agreement with this commercial borrower which includes a reduction in monthly payment amounts over a fifteen-month period. At the end of the fifteen-month period, the monthly payment amounts would revert to the original amounts, unless the forbearance agreement is extended or the payment requirements are otherwise modified. In July 2015, the forbearance agreement was extended for twelve months. The Corporation recorded a charge-off of \$1,486,000 in the second quarter 2014 as a result of these modifications, as the payment amounts based on the forbearance agreement are not sufficient to fully amortize the contractual amount of principal outstanding on the loans. The amount of the charge-off was determined based on the excess of the contractual principal due over the present value of the payment amounts provided for in the forbearance agreement, assuming the revised payment amounts would continue until maturity, at the contractual interest rates. After the effect of the \$1,486,000 charge-off related to loans to one commercial borrower described above, there was no allowance for loan losses on loans to that borrower at December 31, 2015 and 2014, while the allowance on the loans amounted to \$1,552,000 at December 31, 2013. There were no other changes in the allowance for loan losses related to TDRs that occurred during the year ended December 31, 2014.

The TDRs in 2013 included interest only payments for an extended period of time on fourteen contracts, extensions of the final maturity date on three contracts, reduction in interest rate on two contracts, and reduction in payment amount for one year on one contract. There was no allowance for loan losses on these loans at December 31, 2013 and no change in the allowance for loan losses resulting from these TDRs in the year ended December 31, 2013.

For 2015, 2014 and 2013, defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months are summarized as follows:

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Year Ended December 31, 2015<br>(Balances in Thousands) |                           |                        |
| Residential mortgage:                                   |                           |                        |
| Residential mortgage loans - first liens                | 1                         | \$ 32                  |

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Year Ended December 31, 2014<br>(Balances in Thousands) |                           |                        |
| Residential mortgage,                                   |                           |                        |
| Residential mortgage loans - first liens                | 3                         | \$ 257                 |
| Residential mortgage loans - junior liens               | 1                         | 62                     |
| Commercial,   |                           |                        |
| Commercial loans secured by real estate                 | 1                         | 429                    |
| Commercial construction and land                        | 1                         | 25                     |
| Loans secured by farmland                               | 4                         | 490                    |
| Agricultural loans                                      | 1                         | 13                     |

|   | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Year Ended December 31, 2013<br>(Balances in Thousands) |                           |                        |
| Residential mortgage,                                   |                           |                        |
| Residential mortgage loans - first liens                | 1                         | \$ 85                  |
| Commercial:   |                           |                        |
| Commercial loans secured by real estate                 | 2                         | 588                    |
| Commercial construction and land                        | 1                         | 110                    |
| Agricultural  | 1                         | 13                     |

The events of default in 2015 in the table listed above resulted from the borrower's failure to make timely payments after reduced payment amount for a period of six months on the first lien residential mortgage. There was no allowance for loan losses recorded on this loan at December 31, 2015.

The events of default in 2014 in the table listed above included the borrowers' failure to make timely payments under the following circumstances: (1) for one customer relationship including one of the first lien Residential mortgages, the junior lien Residential mortgage, the Loans secured by farmland and the Agricultural loan, monthly payments of interest only were missed; however, in the fourth quarter 2014, the total principal balance of all of the loans except one of the Loans secured by farmland were fully paid off, and the balance on that loan was paid down to a balance at December 31, 2014 of \$75,000 and at December 31, 2015 of \$69,000; (2) for one of the Residential mortgage loans, monthly payments were missed after the interest rate and monthly payment amount had been reduced; (3) for one of the Residential mortgage loans and the Commercial loan secured by real estate, monthly payments of interest only were missed; and (4) for the Commercial construction and land loan, a monthly payment was missed after the term of the loan had been extended. There were no allowances for loan losses recorded on these loans at December 31, 2014.

The events of default in 2013 in the table above included the borrowers' failure to make timely payments under the following circumstances: (1) for the Residential mortgage loan, the monthly payment amount had been reduced; (2) for the two Commercial loans secured by real estate, monthly payments of interest only were missed; (3) for the Commercial construction and land loan, a monthly payment was missed after the term of the loan had been extended; and (4) for the Agricultural loan, payment at maturity was not made on a loan that had been in interest only status. There were no adjustments to the allowance for loan losses in 2013 as a result of these events of default.

At December 31, 2015 and 2014, the Corporation evaluated loans to the borrowers who defaulted subsequent to restructurings, in determining the specific allowance for loan loss amounts related to the underlying loans. Based on the estimated value of the underlying collateral, net of estimated costs to sell the collateral, the Corporation determined that no allowance for loan losses was required at December 31, 2015 and 2014 for loans for which an event of default had occurred subsequent to restructuring.

At December 31, 2015, the carrying amount of foreclosed residential real estate properties held as a result of obtaining physical possession (included in Foreclosed assets held for sale in the consolidated balance sheet) was \$555,000.

At December 31, 2015, the recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process was \$1,173,000.

## 9. BANK PREMISES AND EQUIPMENT

Bank premises and equipment are summarized as follows:

| (In Thousands)                 | December 31, |          |
|--------------------------------|--------------|----------|
|                                | 2015         | 2014     |
| Land                           | \$2,818      | \$2,818  |
| Buildings and improvements     | 27,092       | 26,973   |
| Furniture and equipment        | 17,922       | 17,412   |
| Construction in progress       | 243          | 98       |
| Total                          | 48,075       | 47,301   |
| Less: accumulated depreciation | (32,669)     | (31,045) |
| Net                            | \$15,406     | \$16,256 |

Depreciation expense included in occupancy expense and furniture and equipment expense was as follows:

| (In Thousands)                  | 2015    | 2014    | 2013    |
|---------------------------------|---------|---------|---------|
| Occupancy expense               | \$954   | \$998   | \$1,022 |
| Furniture and equipment expense | 934     | 942     | 998     |
| Total                           | \$1,888 | \$1,940 | \$2,020 |

## 10. INTANGIBLE ASSETS

There were no changes in the carrying amount of goodwill in 2015 and 2014. The balance in goodwill was \$11,942,000 at December 31, 2015 and 2014. The Corporation did not complete any acquisitions in 2015 or 2014.

The Corporation has adopted ASU No. 2011-08, Intangibles – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment. In testing goodwill for impairment as of December 31, 2015, the Corporation assessed qualitative factors to determine whether it is more likely than not that the fair value of its only reporting unit, its community banking operation, is less than its carrying amount. The qualitative factors assessed included the Corporation's recent financial performance, economic conditions in the Corporation's market area, macroeconomic conditions and other factors. Based on the assessment of qualitative factors, the Corporation determined that it is not more likely than not that the fair value of the community banking operation has fallen below its carrying value, and therefore, the Corporation did not perform the more detailed, two-step goodwill impairment test described in Topic 350. Accordingly, there was no goodwill impairment as of December 31, 2015.

Information related to the core deposit intangibles is as follows:

| (In Thousands)                 | December 31, |         |
|--------------------------------|--------------|---------|
|                                | 2015         | 2014    |
| Gross amount                   | \$2,034      | \$2,034 |
| Less: accumulated amortization | (2,004)      | (1,982) |
| Net                            | \$30         | \$52    |



Amortization expense was \$22,000 in 2015, \$35,000 in 2014 and \$51,000 in 2013. The amount of amortization expense to be recognized each of the ensuing five years is not significant.

## 11. DEPOSITS

At December 31, 2015, the scheduled maturities of time deposits are as follows:

|                |           |
|----------------|-----------|
| (In Thousands) |           |
| 2016           | \$124,562 |
| 2017           | 53,985    |
| 2018           | 19,611    |
| 2019           | 10,091    |
| 2020           | 13,424    |
| Thereafter     | 11        |
|                | \$221,684 |

Included in interest-bearing deposits are time deposits in the amount of \$100,000 or more. As of December 31, 2015, the remaining maturities or time to next re-pricing of time deposits of \$100,000 or more are as follows:

|                                 |          |
|---------------------------------|----------|
| (In Thousands)                  |          |
| Three months or less            | \$35,167 |
| Over 3 months through 12 months | 9,330    |
| Over 1 year through 3 years     | 12,358   |
| Over 3 years                    | 8,248    |
| Total                           | \$65,103 |

Interest expense from time deposits of \$100,000 or more amounted to \$482,000 in 2015, \$563,000 in 2014, and \$721,000 in 2013.

## 12. BORROWED FUNDS

Short-term borrowings include the following:

| (In Thousands)                 | Dec. 31<br>2015 | Dec.<br>31<br>2014 |
|--------------------------------|-----------------|--------------------|
| FHLB-Pittsburgh borrowings     | \$48,581        | \$0                |
| Customer repurchase agreements | 4,915           | 5,537              |
| Total short-term borrowings    | \$53,496        | \$5,537            |

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

| (In Thousands)                              | Dec. 31<br>2015 | Dec.<br>31<br>2014 |
|---|-----------------|--------------------|
| Overnight borrowing                         | \$23,500        | \$ 0               |
| Other short-term advances                   | 25,081          | 0                  |
| Total short-term FHLB-Pittsburgh borrowings | \$48,581        | \$ 0               |

The weighted average interest rate on total short-term borrowings outstanding was 0.60% at December 31, 2015 and 0.10% at December 31, 2014. The maximum amount of total short-term borrowings outstanding at any month-end was \$53,496,000 in 2015, \$7,919,000 in 2014 and \$23,385,000 in 2013.

The Corporation had available credit with other correspondent banks totaling \$45,000,000 at December 31, 2015 and 2014. These lines of credit are primarily unsecured. No amounts were outstanding at December 31, 2015 or December 31, 2014.

The Corporation has a line of credit with the Federal Reserve Bank of Philadelphia's Discount Window. At December 31, 2015, the Corporation had available credit in the amount of \$19,606,000 on this line with no outstanding advances. At December 31, 2014 the Corporation had available credit in the amount of \$25,367,000 on this line with no outstanding advances. As collateral for this line, the Corporation has pledged available-for-sale securities with the carrying value of \$20,039,000 at December 31, 2015 and \$26,092,000 at December 31, 2014.

The FHLB-Pittsburgh loan facility is collateralized by qualifying loans secured by real estate with a book value totaling \$450,883,000 at December 31, 2015 and \$446,780,000 at December 31, 2014. Also, the FHLB-Pittsburgh loan facility requires the Corporation to invest in established amounts of FHLB-Pittsburgh stock. The carrying values of the Corporation's holdings of FHLB-Pittsburgh stock (included in Other Assets) were \$4,527,000 at December 31, 2015 and \$1,454,000 at December 31, 2014. The Corporation's total credit facility with FHLB-Pittsburgh was \$322,709,000 at December 31, 2015, including an unused (available) amount of \$262,361,000. At December 31, 2014, the Corporation's total credit facility with FHLB-Pittsburgh was \$323,067,000, including an unused (available) amount of \$311,007,000.

At December 31, 2015, the overnight borrowing from FHLB-Pittsburgh of \$23,500,000 had an interest rate of 0.43%, and the other short-term advances included 12 advances of \$2,090,000 each maturing monthly throughout 2016, with a weighted average interest rate of 0.86% and rates ranging from 0.54% to 1.052%.

The Corporation engages in repurchase agreements with certain commercial customers. These agreements provide that the Corporation sells specified investment securities to the customers on an overnight basis and repurchases them on the following business day. The weighted average rate paid by the Corporation on customer repurchase agreements was 0.10% at December 31, 2015 and December 31, 2014. The carrying value of the underlying securities was \$12,613,000 at December 31, 2015 and \$15,229,000 at December 31, 2014.

## LONG-TERM BORROWINGS

Long-term borrowings are as follows:

| (In Thousands)             | Dec. 31<br>2015 | Dec. 31<br>2014 |
|----------------------------|-----------------|-----------------|
| FHLB-Pittsburgh borrowings | \$11,767        | \$12,060        |
| Repurchase agreements      | 27,000          | 61,000          |
| Total long-term borrowings | \$38,767        | \$73,060        |

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

| (In Thousands)                             | Dec. 31<br>2015 | Dec. 31<br>2014 |
|--|-----------------|-----------------|
| Loan maturing in 2016 with a rate of 6.86% | \$57            | \$107           |
| Loan maturing in 2017 with a rate of 6.83% | 10              | 16              |
| Loan maturing in 2017 with a rate of 3.81% | 10,000          | 10,000          |
| Loan maturing in 2020 with a rate of 4.79% | 821             | 987             |
| Loan maturing in 2025 with a rate of 4.91% | 879             | 950             |
| Total long-term FHLB-Pittsburgh borrowings | \$11,767        | \$12,060        |

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

| (In Thousands)                                   | Dec. 31<br>2015 | Dec. 31<br>2014 |
|--|-----------------|-----------------|
| Agreement maturing in 2017 with a rate of 3.595% | \$27,000        | \$27,000        |
| Agreement maturing in 2017 with a rate of 4.265% | 0               | 34,000          |
| Total long-term repurchase agreements            | \$27,000        | \$61,000        |

In 2015, the Corporation incurred losses totaling \$2,573,000 on prepayment of \$34,000,000 of the agreement with an interest rate of 4.265%. In 2013, the Corporation incurred a loss of \$1,023,000 on prepayment of the agreement with an interest rate of 3.595%.

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

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

The carrying value of the underlying securities was \$33,780,000 at December 31, 2015 and \$70,982,000 at December 31, 2014, as detailed in the following table:

| (In Thousands)  | December 31,<br>2015 | December 31,<br>2014 |
|---|----------------------|----------------------|
| Mortgage-backed securities  | \$ 15,772            | \$ 24,114            |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 18,008               | 46,868               |
| Total   | \$ 33,780            | \$ 70,982            |

Two of the more significant risks associated with the repurchase agreements are as follows:

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

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

Average daily repurchase agreement borrowings amounted to \$54,304,000 in 2015, \$61,000,000 in 2014 and \$62,630,000 in 2013. The maximum amounts of outstanding borrowings under repurchase agreements with broker-dealers were \$61,000,000 in 2015, \$61,000,000 in 2014 and \$68,000,000 in 2013. The weighted average interest rate on repurchase agreements was 3.99% in 2015, 4.02% in 2014 and 4.01% in 2013.

### **13. EMPLOYEE AND POSTRETIREMENT BENEFIT PLANS**

#### **DEFINED BENEFIT PLANS**

The Corporation sponsors a defined benefit health care plan that provides postretirement medical benefits and life insurance to employees who meet certain age and length of service requirements. Effective January 1, 2013, this plan was amended so that full-time employees no longer accrue service time toward the Corporation-subsidized portion of

the medical benefits. The plan was also amended effective January 1, 2013 to change some of the age and length-of-service requirements for participants to receive some of the benefits provided under the plan. This plan contains a cost-sharing feature, which causes participants to pay for all future increases in costs related to benefit coverage. Accordingly, actuarial assumptions related to health care cost trend rates do not significantly affect the liability balance at December 31, 2015 and December 31, 2014, 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 following table shows the funded status of the defined benefit plans:

(In Thousands)

|  | Pension: |          | Postretirement: |            |
|--|----------|----------|-----------------|------------|
|  | 2015     | 2014     | 2015            | 2014       |
| <b>CHANGE IN BENEFIT OBLIGATION:</b>           |          |          |                 |            |
| Benefit obligation at beginning of year        | \$ 1,085 | \$ 1,733 | \$ 1,378        | \$ 1,391   |
| Service cost                                   | 0        | 0        | 38              | 34         |
| Interest cost                                  | 36       | 73       | 57              | 57         |
| Plan participants' contributions               | 0        | 0        | 203             | 198        |
| Actuarial (gain) loss                          | (46 )    | 76       | 120             | (48 )      |
| Benefits paid                                  | (16 )    | (16 )    | (257 )          | (254 )     |
| Settlement of plan obligation                  | (337 )   | (781 )   | 0               | 0          |
| Benefit obligation at end of year              | \$ 722   | \$ 1,085 | \$ 1,539        | \$ 1,378   |
| <b>CHANGE IN PLAN ASSETS:</b>                  |          |          |                 |            |
| Fair value of plan assets at beginning of year | \$ 1,208 | \$ 1,968 | \$ 0            | \$ 0       |
| Actual return on plan assets                   | (16 )    | 37       | 0               | 0          |
| Employer contribution                          | 0        | 0        | 54              | 56         |
| Plan participants' contributions               | 0        | 0        | 203             | 198        |
| Benefits paid                                  | (16 )    | (16 )    | (257 )          | (254 )     |
| Settlement of plan obligation                  | (337 )   | (781 )   | 0               | 0          |
| Fair value of plan assets at end of year       | \$ 839   | \$ 1,208 | \$ 0            | \$ 0       |
| Funded status at end of year                   | \$ 117   | \$ 123   | \$ (1,539)      | \$ (1,378) |

In 2015, there was a distribution from the plan of \$337,000, or 32% of the plan's total accumulated benefit obligation prior to the distribution. The Corporation recognized a loss of \$87,000 (included in net periodic benefit cost) in 2015 as a result of this settlement. In 2014, there was a distribution from the plan of \$781,000, or 42% of the plan's total accumulated benefit obligation prior to the distribution. The Corporation recognized a loss of \$196,000 (included in net periodic benefit cost) in 2014 as a result of this settlement.

At December 31, 2015 and 2014, the following pension plan and postretirement plan asset and liability amounts were recognized in the consolidated balance sheet:

| Assets and liabilities:                | Pension: |        | Postretirement: |          |
|--|----------|--------|-----------------|----------|
| (In Thousands)                         | 2015     | 2014   | 2015            | 2014     |
| Other assets                           | \$ 117   | \$ 123 |                 |          |
| Accrued interest and other liabilities |          |        | \$ 1,539        | \$ 1,378 |

At December 31, 2015 and 2014, the following items included in accumulated other comprehensive income had not been recognized as components of expense:

Items not yet recognized as a component of net periodic benefit cost:

(In Thousands)

|                    | Pension: |       | Postretirement: |          |
|--------------------|----------|-------|-----------------|----------|
|                    | 2015     | 2014  | 2015            | 2014     |
| Prior service cost | \$ 0     | \$0   | \$(371 )        | \$(402 ) |
| Net actuarial loss | 186      | 269   | 131             | 11       |
| Total              | \$ 186   | \$269 | \$(240 )        | \$(391 ) |



For the defined benefit pension plan, amortization of the net actuarial loss is expected to be \$10,000 in 2016. For the postretirement plan, the estimated amount of prior service cost that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2016 is a reduction in expense of \$31,000, and no net actuarial loss is expected to be amortized in 2016.

The accumulated benefit obligation for the defined benefit pension plan was \$722,000 at December 31, 2015 and \$1,085,000 at December 31, 2014.

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

| (In Thousands)                     | Pension: |       |      | Postretirement: |       |      |
|------------------------------------|----------|-------|------|-----------------|-------|------|
|                                    | 2015     | 2014  | 2013 | 2015            | 2014  | 2013 |
| Service cost                       | \$ 0     | \$0   | \$0  | \$ 38           | \$ 34 | \$41 |
| Interest cost                      | 36       | 73    | 71   | 57              | 57    | 55   |
| Expected return on plan assets     | (45 )    | (88 ) | (90) | 0               | 0     | 0    |
| Amortization of prior service cost | 0        | 0     | 0    | (31 )           | (31 ) | (31) |
| Recognized net actuarial loss      | 11       | 19    | 32   | 0               | 0     | 1    |
| Loss on settlement                 | 87       | 196   | 0    | 0               | 0     | 0    |
| Total net periodic benefit cost    | \$ 89    | \$200 | \$13 | \$ 64           | \$ 60 | \$66 |

The weighted-average assumptions used to determine net periodic benefit cost are as follows:

| Citizens Trust Company Retirement Plan and postretirement plan: | Pension: |       |       | Postretirement: |        |        |
|---|----------|-------|-------|-----------------|--------|--------|
|   | 2015     | 2014  | 2013  | 2015            | 2014   | 2013   |
| Discount rate   | 3.75 %   | 4.50% | 4.00% | 4.00 %          | 4.00 % | 4.00 % |
| Expected return on plan assets                                  | 5.31 %   | 5.31% | 5.31% | N/A             | N/A    | N/A    |
| Rate of compensation increase                                   | N/A      | N/A   | N/A   | N/A             | N/A    | N/A    |

The weighted-average assumptions used to determine benefit obligations as of December 31, 2015 and 2014 are as follows:

|  | Pension: |      | Postretirement: |      |
|--|----------|------|-----------------|------|
|  | 2015     | 2014 | 2015            | 2014 |
|  |          |      |                 |      |

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|                               |      |   |       |       |       |
|-------------------------------|------|---|-------|-------|-------|
| Discount rate                 | 4.30 | % | 3.75% | 4.25% | 4.00% |
| Rate of compensation increase | N/A  |   | N/A   | N/A   | N/A   |

Estimated future benefit payments, including only estimated employer contributions for the postretirement plan, which reflect expected future service, are as follows:

| (In Thousands) | Pension | Postretirement |
|----------------|---------|----------------|
| 2016           | \$ 250  | \$ 92          |
| 2017           | 15      | 96             |
| 2018           | 14      | 102            |
| 2019           | 39      | 105            |
| 2020           | 13      | 110            |
| 2021-2025      | 214     | 550            |

No estimated minimum contribution to the defined benefit pension plan is required in 2016, though the Corporation may make discretionary contributions.

The expected return on pension plan (Citizens Trust Company Retirement Plan) assets is a significant assumption used in the calculation of net periodic benefit cost. This assumption reflects the average long-term rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation.

The fair values of pension plan assets at December 31, 2015 and 2014 are as follows:

|                           | 2015 |   | 2014 |   |
|---------------------------|------|---|------|---|
| Cash and cash equivalents | 2    | % | 3    | % |
| Debt securities           | 38   | % | 37   | % |
| Equity securities         | 46   | % | 47   | % |
| Alternative funds         | 14   | % | 13   | % |
| Total                     | 100  | % | 100  | % |

C&N Bank's Trust and Financial Management Department manages the investment of the Citizens Trust Company Retirement Plan (pension plan) assets. Most of the Plan's securities are mutual funds, including mutual funds principally invested in debt securities, mutual funds invested in a diversified mix of large, mid- and small-capitalization U.S. stocks, foreign stocks, and mutual funds invested in alternative asset classes such as real estate, commodities, and inflation-protected securities. The fair values of plan assets are determined based on Level 1 inputs (as described in Note 6). At December 31, 2015, the targeted asset allocation for the pension plan was 46% equity securities, 38% debt securities, 14% alternative assets, and 2% cash. At December 31, 2014, the targeted asset allocation for the pension plan was 26% equity securities, 61% debt securities, 11% alternative assets and 2% cash. The pension plan's assets do not include any shares of the Corporation's common stock.

#### PROFIT SHARING AND DEFERRED COMPENSATION PLANS

The Corporation has a profit sharing plan that incorporates the deferred salary savings provisions of Section 401(k) of the Internal Revenue Code. The Corporation's matching contributions to the Plan depend upon the tax deferred contributions of employees. The Corporation's total basic and matching contributions were \$609,000 in 2015, \$595,000 in 2014 and \$557,000 in 2013.

The Corporation has an Employee Stock Ownership Plan (ESOP). Contributions to the ESOP are discretionary, and the ESOP uses funds contributed to purchase Corporation stock for the accounts of ESOP participants. These purchases are made on the market (not directly from the Corporation), and employees are not permitted to purchase Corporation stock under the ESOP. The ESOP includes a diversification feature, which allows participants, upon reaching age 55 and 10 years of service (as defined), to sell up to 50% of their Corporation shares back to the ESOP over a period of 6 years. As of December 31, 2015 and 2014, there were no shares allocated for repurchase by the ESOP.

Dividends paid on shares held by the ESOP are charged to retained earnings. All Corporation shares owned through the ESOP are included in the calculation of weighted-average shares outstanding for purposes of calculating earnings

per share - basic and diluted. The ESOP held 410,004 shares of Corporation stock at December 31, 2015 and 409,197 shares at December 31, 2014, all of which had been allocated to Plan participants. The Corporation's contributions to the ESOP totaled \$522,000 in 2015, \$512,000 in 2014 and \$509,000 in 2013.

The Corporation has a nonqualified supplemental deferred compensation arrangement with its key officers. Charges to operating expense for officers' supplemental deferred compensation were \$167,000 in 2015, \$138,000 in 2014 and \$186,000 in 2013.

In December 2015, the Corporation established an additional nonqualified deferred compensation plan that allows selected officers, beginning in 2016, the option to defer receipt of cash compensation, including base salary and any cash bonuses or other cash incentives. This nonqualified deferred compensation plan does not provide for Corporation contributions.

#### STOCK-BASED COMPENSATION PLANS

The Corporation has a Stock Incentive Plan for a selected group of senior officers. A total of 850,000 shares of common stock may be issued under the Stock Incentive Plan. Awards may be made under the Stock Incentive Plan in the form of qualified options ("Incentive Stock Options," as defined in the Internal Revenue Code), nonqualified options, stock appreciation rights or restricted stock. Historically through December 31, 2015, all awards made under this Plan have consisted of Incentive Stock Options or restricted stock. Incentive Stock Options have an exercise price equal to the market value of the stock at the date of grant, vest after 6 months and expire after 10 years. Restricted stock awards issued under the Stock Incentive Plan vest ratably over terms ranging from 3-4 years. Restricted stock awards in 2015 included the following: (1) a total of 20,298 shares to employees, vesting over a four-year term, with vesting contingent upon the Corporation meeting an annual return on average equity ("ROAE") performance ratio, as defined; (2) a total of 2,198 shares to employees, vesting over a four-year term, with vesting dependent on satisfactory performance; and (3) an award to the Chief Executive Officer of 5,174 shares, vesting over a three-year term, with vesting dependent on satisfactory performance. Most of the restricted stock awards issued under this Plan in 2015, 2014 and 2013 include a condition that the Corporation must meet an annual targeted return on average equity ("ROAE") performance ratio, as defined, in order for participants to vest. The Corporation met the ROAE target for the 2015, 2014 and 2013 plan years. For 2015 and 2014 restricted stock awards to individuals who are substantially involved in mortgage lending, vesting is not dependent on the Corporation's ROAE. There are 294,275 shares available for issuance under the Stock Incentive Plan as of December 31, 2015.

Also, the Corporation has an Independent Directors Stock Incentive Plan. This plan permits awards of nonqualified stock options and/or restricted stock to non-employee directors. A total of 135,000 shares of common stock may be issued under the Independent Directors Stock Incentive Plan. The recipients' rights to exercise stock options under this plan expire 10 years from the date of grant. The exercise prices of all stock options awarded under the Independent Directors Stock Incentive Plan are equal to market value as of the dates of grant. In 2015, a total of 7,130 restricted shares were granted under the Independent Directors Stock Incentive Plan, vesting over a term of one year. Restricted stock awards granted under the Independent Directors Stock Incentive Plan in 2014 and 2013 vest ratably over 3 years. There are 29,702 shares available for issuance under the Independent Directors Stock Incentive Plan as of December 31, 2015.

There were no stock options granted in 2015. The Corporation recorded stock option expense in 2014 and 2013 based on estimated fair value calculated using the Black-Scholes-Merton option-pricing model with the following assumptions:

|                         |         |   |         |   |
|-------------------------|---------|---|---------|---|
|                         | 2014    |   | 2013    |   |
| Volatility              | 39      | % | 41      | % |
| Expected option lives   | 8 Years |   | 8 Years |   |
| Risk-free interest rate | 2.85    | % | 1.60    | % |
| Dividend yield          | 4.33    | % | 3.69    | % |

Management estimated the lives for options based on the Corporation's average historical experience with both plans. The Corporation utilized its historical volatility and dividend yield over the immediately prior 8-year period to estimate future levels of volatility and dividend yield for the 2014 and 2013 awards. The risk-free interest rate was based on the published yield of zero-coupon U.S. Treasury strips as of the grant date, with a maturity coinciding with the estimated option lives.

Total stock-based compensation expense is as follows:

|                  |       |       |       |
|------------------|-------|-------|-------|
| (In Thousands)   | 2015  | 2014  | 2013  |
| Stock options    | \$0   | \$153 | \$242 |
| Restricted stock | 606   | 412   | 454   |
| Total            | \$606 | \$565 | \$696 |

A summary of stock option activity is presented below:

|  |      |          |      |          |      |          |
|--|------|----------|------|----------|------|----------|
|  | 2015 |          | 2014 |          | 2013 |          |
|  |      | Weighted |      | Weighted |      | Weighted |

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|  | Shares    | Average<br>Exercise<br>Price | Shares    | Average<br>Exercise<br>Price | Shares    | Average<br>Exercise<br>Price |
|--|-----------|------------------------------|-----------|------------------------------|-----------|------------------------------|
| Outstanding, beginning of year                   | 316,157   | \$ 19.05                     | 358,176   | \$ 19.03                     | 337,670   | \$ 19.08                     |
| Granted  | 0         |                              | 39,027    | \$ 20.45                     | 64,050    | \$ 19.21                     |
| Exercised  | (29,557 ) | \$ 17.56                     | (50,415 ) | \$ 17.57                     | (10,656 ) | \$ 17.22                     |
| Forfeited  | (20,211 ) | \$ 19.76                     | (16,424 ) | \$ 20.03                     | (14,135 ) | \$ 20.13                     |
| Expired  | (17,903 ) | \$ 27.00                     | (14,207 ) | \$ 26.59                     | (18,753 ) | \$ 20.73                     |
| Outstanding, end of year                         | 248,486   | \$ 18.59                     | 316,157   | \$ 19.05                     | 358,176   | \$ 19.03                     |
| Options exercisable at year-end                  | 248,486   | \$ 18.59                     | 316,157   | \$ 19.05                     | 358,176   | \$ 19.03                     |
| Weighted-average fair value of options granted   |           | N/A                          |           | \$ 5.50                      |           | \$ 5.56                      |
| Weighted-average fair value of options forfeited |           | \$ 4.86                      |           | \$ 4.89                      |           | \$ 3.77                      |

The weighted-average remaining contractual term of outstanding stock options at December 31, 2015 was 4.6 years. The aggregate intrinsic value of stock options outstanding (excluding options issued at exercise prices greater than the final closing price of the Corporation's stock in 2015) was \$629,000 at December 31, 2015. The total intrinsic value of options exercised was \$77,000 in 2015, \$90,000 in 2014 and \$29,000 in 2013.

The following summarizes non-vested restricted stock activity for the year ended December 31, 2015:

|                                | Restricted Stock |  |
|--------------------------------|------------------|--|
|                                | Number of Shares | Weighted Average Grant Date Fair Value |
| Outstanding, December 31, 2014 | 52,436           | \$ 19.34                               |
| Granted                        | 34,800           | \$ 20.63                               |
| Vested                         | (21,522)         | \$ 19.16                               |
| Forfeited                      | (3,502 )         | \$ 20.08                               |
| Outstanding, December 31, 2015 | 62,212           | \$ 20.10                               |

Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. As of December 31, 2015, there was \$645,000 total unrecognized compensation costs related to restricted stock, which is expected to be recognized over a weighted average period of 1.7 years.

In the first two months of 2016, the Corporation awarded 27,593 shares of restricted stock under the Stock Incentive Plan and 6,606 shares of restricted stock under the Independent Directors Stock Incentive Plans. The 2016 restricted stock awards under the Stock Incentive Plan vest ratably over three years, and vesting for 8,645 of the restricted shares depends on the Corporation meeting a ROAE target each year. The 2016 restricted stock issued under the Independent Directors Stock Incentive Plan vests over one year. Total estimated stock-based compensation for 2016 is \$651,000. The restricted stock awards made in the first two months of 2016 are not included in the tables above.

The Corporation has issued shares from treasury stock for almost all stock option exercises through December 31, 2015. Management does not anticipate that stock repurchases will be necessary to accommodate stock option exercises in 2016.

#### 14. INCOME TAXES

The net deferred tax asset at December 31, 2015 and 2014 represents the following temporary difference components:

| (In Thousands)       | December 31, 2015 | December 31, 2014 |
|----------------------|-------------------|-------------------|
| Deferred tax assets: |                   |                   |

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|   |       |        |
|---|-------|--------|
| Net realized losses on securities       | \$ 69 | \$ 144 |
| Allowance for loan losses               | 2,761 | 2,568  |
| Credit for alternative minimum tax paid | 0     | 537    |
| Other deferred tax assets               | 2,634 | 2,595  |
| Total deferred tax assets               | 5,464 | 5,844  |

Deferred tax liabilities:

|  |          |          |
|--|----------|----------|
| Unrealized holding gains on securities | 1,342    | 2,844    |
| Defined benefit plans - ASC 835        | 19       | 43       |
| Bank premises and equipment            | 869      | 1,134    |
| Core deposit intangibles               | 11       | 18       |
| Other deferred tax liabilities         | 108      | 137      |
| Total deferred tax liabilities         | 2,349    | 4,176    |
| Deferred tax asset, net                | \$ 3,115 | \$ 1,668 |

The provision for income taxes includes the following:

| (In thousands)   | 2015    | 2014    | 2013    |
|--|---------|---------|---------|
| Currently payable  | \$5,097 | \$4,280 | \$4,125 |
| Tax expense resulting from allocations of certain tax benefits to equity or as a reduction in other assets | 161     | 158     | 219     |
| Deferred   | 79      | 1,254   | 1,839   |
| Total provision  | \$5,337 | \$5,692 | \$6,183 |



A reconciliation of income tax at the statutory rate to the Corporation's effective rate is as follows (amounts in thousands):

| (Amounts in thousands)                             | 2015    |        | 2014    |        | 2013    |        |
|--|---------|--------|---------|--------|---------|--------|
|  | Amount  | %      | Amount  | %      | Amount  | %      |
| Expected provision                                 | \$7,633 | 35.00  | \$7,972 | 35.00  | \$8,672 | 35.00  |
| Tax-exempt interest income                         | (1,914) | (8.78) | (1,982) | (8.70) | (2,137) | (8.62) |
| Nondeductible interest expense                     | 51      | 0.23   | 56      | 0.25   | 60      | 0.24   |
| Dividends received deduction                       | (75)    | (0.34) | (79)    | (0.35) | (76)    | (0.31) |
| Increase in cash surrender value of life insurance | (135)   | (0.62) | (132)   | (0.58) | (140)   | (0.57) |
| Employee stock option compensation                 | 0       | 0.00   | 41      | 0.18   | 67      | 0.27   |
| Tax benefit from limited partnership investment    | (80)    | (0.37) | (83)    | (0.36) | (85)    | (0.34) |
| Other, net   | (143)   | (0.66) | (101)   | (0.44) | (178)   | (0.72) |
| Effective income tax provision                     | \$5,337 | 24.47  | \$5,692 | 24.99  | \$6,183 | 24.95  |

The Corporation has investments in three limited partnerships that manage affordable housing projects that have qualified for the federal low-income housing tax credit. The Corporation's expected return from these investments is based on the receipt of tax credits and tax benefits from deductions of operating losses. The Corporation uses the effective yield method to account for these investments, with the benefits recognized as a reduction of the provision for income taxes. For two of the three limited partnership investments, the tax credits have been received in full in prior years, and the Corporation has fully realized the benefits of the credits and amortized its initial investments in the partnerships. The most recent affordable housing project was completed in 2013, and the Corporation received tax credits in 2013 and 2014 and expects to continue to receive tax credits annually through 2022. The carrying amount of the Corporation's investment is \$812,000 at December 31, 2015 and \$906,000 at December 31, 2014 (included in Other Assets in the consolidated balance sheets). For 2015, the estimated amount of tax credits and other tax benefits to be received is \$158,000 and the amount recognized as a reduction of the provision for income taxes is \$80,000. In 2014, the Corporation received tax credits and other tax benefits totaling \$159,000, and recognized a reduction of the provision for income tax of \$83,000. In 2013, the Corporation received tax credits and other tax benefits totaling \$160,000, and recognized a reduction of the provision for income tax of \$85,000.

The Corporation has no unrecognized tax benefits, nor pending examination issues related to tax positions taken in preparation of its income tax returns. With limited exceptions, the Corporation is no longer subject to examination by the Internal Revenue Service for years prior to 2011.

## 15. RELATED PARTY TRANSACTIONS

Loans to executive officers, directors of the Corporation and its subsidiaries and any associates of the foregoing persons are as follows:

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| (In Thousands)                          | Beginning<br>Balance | New<br>Loans | Repayments | Other<br>Changes | Ending<br>Balance |
|---|----------------------|--------------|------------|------------------|-------------------|
| 11 directors, 7 executive officers 2015 | \$ 12,023            | \$52         | \$ (808 )  | \$ (1,021 )      | \$ 10,246         |
| 12 directors, 8 executive officers 2014 | 12,547               | 188          | (1,358 )   | 646              | 12,023            |
| 11 directors, 8 executive officers 2013 | 14,125               | 1,110        | (2,723 )   | 35               | 12,547            |

In the table above, other changes represent net changes in the balance of existing lines of credit and transfers in and out of the related party category.

Deposits from related parties held by the Corporation amounted to \$3,194,000 at December 31, 2015 and \$3,203,000 at December 31, 2014.

## 16. OFF-BALANCE SHEET RISK

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit, interest rate or liquidity risk in excess of the amount recognized in the consolidated balance sheet. The contract amounts of these instruments express the extent of involvement the Corporation has in particular classes of financial instruments.

The Corporation's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments whose contract amounts represent credit risk at December 31, 2015 and 2014 are as follows:

|                              |           |           |
|------------------------------|-----------|-----------|
| (In Thousands)               | 2015      | 2014      |
| Commitments to extend credit | \$156,407 | \$143,863 |
| Standby letters of credit    | 13,340    | 13,415    |

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation, for extensions of credit is based on management's credit assessment of the counterparty.

Standby letters of credit are conditional commitments issued by the Corporation guaranteeing performance by a customer to a third party. Those guarantees are issued primarily to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Some of the standby letters of credit are collateralized by real estate or other assets, and others are unsecured. The extent to which proceeds from liquidation of collateral would be expected to cover the maximum potential amount of future payments related to standby letters of credit is not estimable. The Corporation has recorded no liability associated with standby letters of credit as of December 31, 2015 and 2014.

Standby letters of credit as of December 31, 2015 expire as follows:

|                     |                       |
|---------------------|-----------------------|
|                     | Amount                |
| Year of Expiration  | <b>(In Thousands)</b> |
| 2016                | \$10,767              |
| 2017                | 371                   |
| 2019                | 40                    |
| 2021 and Thereafter | 2,162                 |
| Total               | \$13,340              |

## 17. CONTINGENCIES

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

## **18. REGULATORY MATTERS**

The Corporation (on a consolidated basis) and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and C&N Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and C&N Bank to maintain minimum amounts and ratios (set forth in the following table) of total capital, Tier I capital (as defined in the regulations) and Common equity Tier 1 capital (as defined) to risk-weighted assets (as defined) and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2015 and 2014, that the Corporation and C&N Bank meet all capital adequacy requirements to which they are subject.

To be categorized as well capitalized, an institution must maintain minimum total risk based, Tier I risk based, Common equity risk based and Tier I leverage ratios as set forth in the following table. The Corporation's and C&N Bank's actual capital amounts and ratios are also presented in the following table:

(Dollars in Thousands)

|   | Actual     |        | Minimum Capital Requirement |        | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|------------|--------|-----------------------------|--------|--|--------|
|   | Amount     | Ratio  | Amount                      | Ratio  | Amount   | Ratio  |
| December 31, 2015:                                    |            |        |                             |        |  |        |
| Total capital to risk-weighted assets:                |            |        |                             |        |  |        |
| Consolidated  | \$ 181,216 | 24.40% | \$ 59,424                   | 38 %   | \$ 74,281  | 310 %  |
| C&N Bank  | 161,187    | 21.83% | 59,058                      | 38 %   | 73,823   | 310 %  |
| Tier 1 capital to risk-weighted assets:               |            |        |                             |        |  |        |
| Consolidated  | 173,009    | 23.29% | 29,712                      | 36 %   | 59,424   | 38 %   |
| C&N Bank  | 153,298    | 20.77% | 29,529                      | 36 %   | 59,058   | 38 %   |
| Common equity tier 1 capital to risk-weighted assets: |            |        |                             |        |  |        |
| Consolidated  | 173,009    | 23.29% | 29,712                      | 34.5 % | 48,282   | 36.5 % |
| C&N Bank  | 153,298    | 20.77% | 29,529                      | 34.5 % | 47,985   | 36.5 % |
| Tier 1 capital to average assets:                     |            |        |                             |        |  |        |
| Consolidated  | 173,009    | 14.31% | 48,355                      | 34 %   | 60,444   | 35 %   |
| C&N Bank  | 153,298    | 12.81% | 47,861                      | 34 %   | 59,826   | 35 %   |
| December 31, 2014:                                    |            |        |                             |        |  |        |
| Total capital to risk-weighted assets:                |            |        |                             |        |  |        |
| Consolidated  | \$ 179,588 | 27.60% | \$ 52,051                   | 38 %   | n/a  | n/a    |
| C&N Bank  | 156,420    | 24.33% | 51,442                      | 38 %   | \$ 64,303  | 310 %  |
| Tier 1 capital to risk-weighted assets:               |            |        |                             |        |  |        |
| Consolidated  | 170,880    | 26.26% | 26,026                      | 34 %   | n/a  | n/a    |
| C&N Bank  | 149,055    | 23.18% | 25,721                      | 34 %   | 38,582   | 36 %   |
| Tier 1 capital to average assets:                     |            |        |                             |        |  |        |
| Consolidated  | 170,880    | 13.89% | 49,224                      | 34 %   | n/a  | n/a    |
| C&N Bank  | 149,055    | 12.22% | 48,798                      | 34 %   | 60,998   | 35 %   |

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



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

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

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

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

Banking regulators limit the amount of dividends that may be paid by C&N Bank to the Corporation. Retained earnings against which dividends may be paid without prior approval of the banking regulators amounted to approximately \$87,471,000 at December 31, 2015, subject to the minimum capital ratio requirements noted above.

Restrictions imposed by federal law prohibit the Corporation from borrowing from C&N Bank unless the loans are secured in specific amounts. Such secured loans to the Corporation are generally limited to 10% of C&N Bank's tangible stockholder's equity (excluding accumulated other comprehensive income) or \$15,733,000 at December 31, 2015.



**19. PARENT COMPANY ONLY**

The following is condensed financial information for Citizens & Northern Corporation:

| CONDENSED BALANCE SHEET<br>(In Thousands)  | December 31,     |                  |
|--|------------------|------------------|
|  | 2015             | 2014             |
| <b>ASSETS</b>                              |                  |                  |
| Cash                                       | \$5,847          | \$9,624          |
| Investment in subsidiaries:                |                  |                  |
| Citizens & Northern Bank                   | 167,277          | 164,551          |
| Citizens & Northern Investment Corporation | 10,966           | 10,822           |
| Bucktail Life Insurance Company            | 3,392            | 3,336            |
| Other assets                               | 24               | 36               |
| <b>TOTAL ASSETS</b>                        | <b>\$187,506</b> | <b>\$188,369</b> |

| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |                  |                  |
|---|------------------|------------------|
| Other liabilities                                 | \$19             | \$7              |
| Stockholders' equity                              | 187,487          | 188,362          |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$187,506</b> | <b>\$188,369</b> |

| CONDENSED INCOME STATEMENT<br>(In Thousands)                 | 2015                                    | 2014            | 2013            |
|--|---|-----------------|-----------------|
|  | Dividends from Citizens & Northern Bank | \$11,569        | \$22,608        |
| Expenses   | (234 )                                  | (112 )          | (108 )          |
| Income before equity in undistributed income of subsidiaries | 11,335                                  | 22,496          | 11,000          |
| Equity in undistributed income (loss) of subsidiaries        | 5,136                                   | (5,410 )        | 7,594           |
| <b>NET INCOME</b>  | <b>\$16,471</b>                         | <b>\$17,086</b> | <b>\$18,594</b> |

| CONDENSED STATEMENT OF CASH FLOWS<br>(In Thousands)                               | 2015   | 2014     | 2013     |
|---|--|----------|----------|
|   | <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b> |          |          |
| Net income  | \$16,471                                     | \$17,086 | \$18,594 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |          |          |
| Equity in undistributed net (income) loss of subsidiaries                         | (5,136 )                                     | 5,410    | (7,594 ) |
| Decrease (increase) in other assets   | 12   | (36 )    | 7        |
| Increase in other liabilities   | 12   | 1        | 0        |
| Net Cash Provided by Operating Activities   | 11,359                                       | 22,461   | 11,007   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |  |          |          |
| Proceeds from sale of treasury stock  | 381  | 123      | 184      |
| Tax benefit from compensation plans, net  | 143  | 137      | 127      |

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|  |          |          |          |
|--|----------|----------|----------|
| Purchase of treasury stock                       | (4,415 ) | (4,002 ) | 0        |
| Dividends paid                                   | (11,245) | (11,392) | (10,916) |
| Net Cash (Used in) Financing Activities          | (15,136) | (15,134) | (10,605) |
| <br>   |          |          |          |
| (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (3,777 ) | 7,327    | 402      |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR     | 9,624    | 2,297    | 1,895    |
| CASH AND CASH EQUIVALENTS, END OF YEAR           | \$5,847  | \$9,624  | \$2,297  |

**20. SUMMARY OF QUARTERLY CONSOLIDATED FINANCIAL DATA (Unaudited)**

The following table presents summarized quarterly financial data for 2015 and 2014:

(In Thousands Except Per Share Data) (Unaudited)

|  | 2015 Quarter Ended |           |           |           |
|--|--------------------|-----------|-----------|-----------|
|  | Mar. 31,           | June 30,  | Sept. 30, | Dec. 31,  |
| Interest income  | \$ 11,163          | \$ 11,186 | \$ 11,134 | \$ 11,036 |
| Interest expense   | 1,213              | 1,176     | 1,126     | 1,087     |
| Net interest income  | 9,950              | 10,010    | 10,008    | 9,949     |
| Provision for loan losses                                    | 3                  | 221       | 302       | 319       |
| Net interest income after provision for loan losses          | 9,947              | 9,789     | 9,706     | 9,630     |
| Other income   | 3,487              | 3,962     | 3,961     | 3,994     |
| Net gains on available-for-sale securities                   | 74                 | 932       | 79        | 1,776     |
| Loss on prepayment of borrowings                             | 0                  | 910       | 0         | 1,663     |
| Other expenses   | 8,464              | 7,964     | 8,117     | 8,411     |
| Income before income tax provision                           | 5,044              | 5,809     | 5,629     | 5,326     |
| Income tax provision   | 1,229              | 1,452     | 1,395     | 1,261     |
| Net income   | \$ 3,815           | \$ 4,357  | \$ 4,234  | \$ 4,065  |
| Net income per share – basic                                 | \$ 0.31            | \$ 0.36   | \$ 0.35   | \$ 0.33   |
| Net income per share – diluted                               | \$ 0.31            | \$ 0.36   | \$ 0.35   | \$ 0.33   |
|  |                    |           |           |           |
|  | 2014 Quarter Ended |           |           |           |
|  | Mar. 31,           | June 30,  | Sept. 30, | Dec. 31,  |
| Interest income  | \$ 11,406          | \$ 11,563 | \$ 11,572 | \$ 11,468 |
| Interest expense   | 1,288              | 1,290     | 1,287     | 1,257     |
| Net interest income  | 10,118             | 10,273    | 10,285    | 10,211    |
| (Credit) provision for loan losses                           | (311 )             | 446       | 218       | 123       |
| Net interest income after (credit) provision for loan losses | 10,429             | 9,827     | 10,067    | 10,088    |
| Other income   | 3,751              | 3,980     | 3,887     | 3,802     |
| Net gains on available-for-sale securities                   | 31                 | 103       | 760       | 210       |
| Other expenses   | 8,524              | 8,347     | 9,036     | 8,250     |
| Income before income tax provision                           | 5,687              | 5,563     | 5,678     | 5,850     |
| Income tax provision   | 1,399              | 1,400     | 1,411     | 1,482     |
| Net income   | \$ 4,288           | \$ 4,163  | \$ 4,267  | \$ 4,368  |
| Net income per share – basic                                 | \$ 0.35            | \$ 0.33   | \$ 0.34   | \$ 0.36   |
| Net income per share – diluted                               | \$ 0.34            | \$ 0.33   | \$ 0.34   | \$ 0.35   |

Report of Independent Registered Public Accounting Firm

Stockholders and Board of Directors of Citizens & Northern Corporation:

We have audited the accompanying consolidated balance sheets of Citizens & Northern Corporation and subsidiaries as of December 31, 2015 and 2014 and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2015. Citizens & Northern Corporation and subsidiaries' management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citizens & Northern Corporation and subsidiaries as of December 31, 2015 and 2014, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Citizens & Northern Corporation and subsidiaries' internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control-Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 18, 2016 expressed an unqualified opinion.

/s/ Baker Tilly Virchow Krause, LLP

Williamsport, Pennsylvania

February 18, 2016



**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

**ITEM 9A. CONTROLS AND PROCEDURES**

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

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

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

**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Corporation's management is responsible for establishing and maintaining effective internal control over financial reporting, as that term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). The Corporation's system of internal control over financial reporting has been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Corporation's internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Corporation's assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements

in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Corporation are being made only in accordance with authorizations of the Corporation's management and directors; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use or disposition of the Corporation's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

The Corporation's management assessed the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2015, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework* (2013). Based on that assessment, we concluded that, as of December 31, 2015, the Corporation's internal control over financial reporting is effective based on the criteria established in *Internal Control – Integrated Framework* (2013).

Baker Tilly Virchow Krause, LLP, the independent registered public accounting firm that audited the Corporation's consolidated financial statements, has issued an audit report on the Corporation's internal control over financial reporting as of December 31, 2015. That report appears below.

February 18, 2016 By: /s/ J. Bradley Scovill  
Date President and Chief Executive Officer

February 18, 2016 By: /s/ Mark A. Hughes  
Date Treasurer and Chief Financial Officer

## Report Of Independent Registered Public Accounting Firm

Stockholders and Board of Directors of Citizens & Northern Corporation:

We have audited Citizens & Northern Corporation and subsidiaries' internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control-Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Citizens & Northern Corporation and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on Citizens & Northern Corporation and subsidiaries' internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Citizens & Northern Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control – Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows of Citizens & Northern Corporation and subsidiaries, and our report dated February 18, 2016 expressed an unqualified opinion.

/s/ Baker Tilly Virchow Krause, LLP

Williamsport, Pennsylvania

February 18, 2016

**ITEM 9B. OTHER INFORMATION**

There was no information the Corporation was required to disclose in a report on Form 8-K during the fourth quarter 2015 that was not disclosed.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information concerning Directors and Executive Officers is incorporated herein by reference to disclosure under the captions “Proposal 1 - Election of Directors,” “Executive Officers,” “Information Concerning Security Ownership” and “Meetings and Committees of the Board of Directors” of the Corporation’s proxy statement dated March 11, 2016 for the annual meeting of stockholders to be held on April 21, 2016.

The Corporation’s Board of Directors has adopted a Code of Ethics, available on the Corporation’s web site at [www.cnbankpa.com](http://www.cnbankpa.com) for the Corporation’s employees, officers and directors. (The provisions of the Code of Ethics are also included in the Corporation’s employee handbook.)

**ITEM 11. EXECUTIVE COMPENSATION**

Information concerning executive compensation is incorporated herein by reference to disclosure under the captions “Compensation Discussion and Analysis” and “Executive Compensation Tables” of the Corporation’s proxy statement dated March 11, 2016 for the annual meeting of stockholders to be held on April 21, 2016.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information concerning security ownership of certain beneficial owners and management is incorporated herein by reference to disclosure under the caption “Beneficial Ownership of Executive Officers and Directors” of the Corporation’s proxy statement dated March 11, 2016 for the annual meeting of stockholders to be held on April 21, 2016.

“Equity Compensation Plan Information” as required by Item 201(d) of Regulation S-K is incorporated by reference herein from Item 5 (Market for Registrant’s Common Equity and Related Stockholder Matters) of this Form 10-K.

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

Information concerning loans and deposit balances with Directors and Executive Officers is provided in Note 15 to the Consolidated Financial Statements, which is included in Part II, Item 8 of this Annual Report on Form 10-K.

Additional information, including information concerning director independence, is incorporated herein by reference to disclosure appearing under the captions “Director Independence” and “Related Person Transaction and Policies” of the Corporation’s proxy statement dated March 11, 2016 for the annual meeting of stockholders to be held on April 21, 2016.

### **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information concerning services provided by the Corporation’s independent auditor Baker Tilly Virchow Krause LLP , the audit committee’s pre-approval policies and procedures for such services, and fees paid by the Corporation to that firm, is incorporated herein by reference to disclosure under the caption “Fees of Independent Public Accountants” of the Corporation’s proxy statement dated March 11, 2016 for the annual meeting of stockholders to be held on April 21, 2016.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) (1). The following consolidated financial statements are set forth in Part II, Item 8:

|  |            |
|--|------------|
| <u>Report of Independent Registered Public Accounting Firm</u>   | Page<br>86 |
| <u>Financial Statements:</u>   |            |
| <u>Consolidated Balance Sheets - December 31, 2015 and 2014</u>  | 38         |
| <u>Consolidated Statements of Income - Years Ended December 31, 2015, 2014 and 2013</u>                          | 39         |
| <u>Consolidated Statements of Comprehensive Income - Years Ended December 31, 2015, 2014 and 2013</u>            | 40         |
| <u>Consolidated Statements of Changes in Stockholders' Equity - Years Ended December 31, 2015, 2014 and 2013</u> | 41         |
| <u>Consolidated Statements of Cash Flows - Years Ended December 31, 2015, 2014 and 2013</u>                      | 42         |
| <u>Notes to Consolidated Financial Statements</u>  | 43-85      |

(a)(2) Financial statement schedules are not applicable or included in the financial statements or related notes.

|   |   |
|---|---|
| 2. Plan of acquisition, reorganization, arrangement, liquidation or succession  | Not applicable  |
| 3. (i) Articles of Incorporation  | Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed September 21, 2009 |
| 3. (ii) By-laws   | Incorporated by reference to Exhibit 3.2 of the Corporation's Form 8-K filed September 21, 2009 |
| 4. Instruments defining the rights of Security holders, including indentures  | Not applicable  |
| 9. Voting trust agreement   | Not applicable  |
| 10. Material contracts:   |   |
| 10.1 Form of Restricted Stock agreement dated January 5, 2016 between the Corporation and Executive Officers pursuant to the Citizens & Northern Corporation Stock Incentive Plan | Filed herewith  |

10.2 Form of Restricted Stock agreement dated January 5, 2016 between the Corporation and certain non-executive officers pursuant to the Citizens & Northern Corporation Stock Incentive Plan Filed herewith

10.3 Form of Restricted Stock agreement dated January 5, 2016 between the Corporation and its independent directors pursuant to the Citizens & Northern Corporation Independent Directors Stock Incentive Plan Filed herewith

10.4 Form of Restricted Stock agreement dated February 2, 2016 between the Corporation and J. Bradley Scovill pursuant to the Citizens & Northern Corporation Stock Incentive Plan Filed herewith

|  |   |
|--|---|
| 10.5 2016 Annual Performance Incentive Award Plan  | Filed herewith  |
| 10.6 2016 Annual Performance Incentive Award Plan - Mortgage Lenders   | Filed herewith  |
| 10.7 Employment agreement dated March 2, 2015 between the Corporation and J. Bradley Scovill                           | Incorporated by reference to Exhibit 10.1 filed with Corporation's Form 8-K on February 9, 2015   |
| 10.8 Employment agreement dated September 19, 2013 between the Corporation and Mark A. Hughes                          | Incorporated by reference to Exhibit 10.2 filed with Corporation's Form 8-K on September 19, 2013 |
| 10.9 Employment agreement dated September 19, 2013 between the Corporation and Harold F. Hoose, III                    | Incorporated by reference to Exhibit 10.3 filed with Corporation's Form 8-K on September 19, 2013 |
| 10.10 Employment agreement dated September 19, 2013 between the Corporation and Deborah E. Scott                       | Incorporated by reference to Exhibit 10.4 filed with Corporation's Form 8-K on September 19, 2013 |
| 10.11 Form of Indemnification Agreement dated February 11, 2015 between the Corporation and Stan R. Dunsmore           | Incorporated by reference to Exhibit 10.9 filed with Corporation's Form 10-K on February 26, 2015 |
| 10.12 Form of Indemnification Agreement dated January 2, 2013 between the Corporation and Shelley L. D'Haene           | Incorporated by reference to Exhibit 10.5 filed with Corporation's Form 10-K on February 21, 2013 |
| 10.13 Form of Indemnification Agreement dated January 19, 2011 between the Corporation and John M. Reber               | Incorporated by reference to Exhibit 10.6 filed with Corporation's Form 10-K on Feb. 28, 2011     |
| 10.14 Form of Indemnification Agreements dated May 2004 between the Corporation and the Directors and certain officers | Incorporated by reference to exhibit 10.1 filed with Corporation's 10-K on March 11, 2005         |
| 10.15 Change in Control Agreement dated March 17, 2015 between the Corporation and Stan R. Dunsmore                    | Incorporated by reference to Exhibit 10.1 filed with Corporation's Form 10-Q on May 8, 2015       |
| 10.16 Change in Control Agreement dated January 2, 2013 between the Corporation and Shelley L. D'Haene                 | Incorporated by reference to Exhibit 10.7 filed with Corporation's Form 10-K on February 21, 2013 |
| 10.17 Change in Control Agreement dated April 15, 2008 between the Corporation and George M. Raup                      | Incorporated by reference to Exhibit 10.9 filed with the Corporation's Form 10-K on March 6, 2009 |
|  | Filed herewith  |

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10.18 Change in Control Agreement dated January 20, 2005 Between the Corporation and John M. Reber

10.19 Change in Control Agreement dated December 31, 2003 between the Corporation and Thomas L. Rudy, Jr.

Incorporated by reference to Exhibit 10.2 filed with the Corporation's Form 10-K

10.20 Third Amendment to Citizens & Northern Corporation Stock Incentive Plan

Incorporated by reference to Exhibit A to the Corporation's proxy statement dated March 18, 2008 for the annual meeting of stockholders held on April 15, 2008

10.21 Second Amendment to Citizens & Northern Corporation Stock Incentive Plan

Incorporated by reference to Exhibit 10.5 filed with the Corporation's Form 10-K on March 10, 2004

10.22 First Amendment to Citizens & Northern Corporation Stock Incentive Plan

Incorporated by reference to Exhibit 10.6 filed with the Corporation's Form 10-K on March 10, 2004

10.23 Citizens & Northern Corporation Stock Incentive Plan

Incorporated by reference to Exhibit 10.7 filed with the Corporation's Form 10-K on March 10, 2004

|  |  |
|--|--|
| 10.24 First Amendment to Citizens & Northern Corporation Independent Directors Stock Incentive Plan    | Incorporated by reference to Exhibit B to the Corporation's proxy statement dated March 18, 2008 for the annual meeting of stockholders held on April 15, 2008   |
| 10.25 Citizens & Northern Corporation Independent Directors Stock Incentive Plan                       | Incorporated by reference to Exhibit A to the Corporation's proxy statement dated March 19, 2001 for the annual meeting of stockholders held on April 17, 2001.  |
| 10.26 Citizens & Northern Corporation Supplemental Executive Retirement Plan (as amended and restated) | Incorporated by reference to Exhibit 10.21 filed with the Corporation's Form 10-K on March 6, 2009   |
| 11. Statement re: computation of per share earnings  | Information concerning the computation of earnings per share is provided in Note 4 to the Consolidated Financial Statements, which is included in Part II, Item 8 of Form 10-K   |
| 12. Statements re: computation of ratios   | Not applicable   |
| 13. Annual report to security holders, Form 10-Q or quarterly report to security holders               | Not applicable   |
| 14. Code of ethics   | The Code of Ethics is available through the Corporation's website at <a href="http://www.cnbankpa.com">www.cnbankpa.com</a> . To access the Code of Ethics, click on "Investor Relations," followed by "Pages within Investor Relations," "Corporate Governance Policies," and "Code of Ethics." |
| 16. Letter re: change in certifying accountant   | Not applicable   |
| 18. Letter re: change in accounting principles   | Not applicable   |
| 21. Subsidiaries of the registrant   | Filed herewith   |
| 22. Published report regarding matters submitted to vote of security holders                           | Not applicable   |
| 23. Consent of Independent Registered Public Accounting Firm   | Filed herewith   |
| 24. Power of attorney  | Not applicable   |
| 31. Rule 13a-14(a)/15d-14(a) certifications:   |  |
| 31.1 Certification of Chief Executive Officer  | Filed herewith   |
| 31.2 Certification of Chief Financial Officer  | Filed herewith   |
| 32. Section 1350 certifications  | Filed herewith   |
|  | Not applicable   |



|  |                |
|--|----------------|
| 33. Report on assessment of compliance with servicing criteria for asset-backed securities                                       |                |
| 34. Attestation report on assessment of compliance with servicing criteria for asset-backed securities                           | Not applicable |
| 35. Service compliance statement   | Not applicable |
| 99. Additional exhibits:   |                |
| 99.1 Additional information mailed or made available online to shareholders with proxy statement and Form 10-K on March 11, 2016 | Filed herewith |
| 100. XBRL-related documents  | Not applicable |
| 101. Interactive data file   | Filed herewith |

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

By: /s/ J. Bradley Scovill  
President and Chief Executive Officer

Date: February 18, 2016

By: /s/ Mark A. Hughes  
Treasurer and Principal Accounting Officer

Date: February 18, 2016

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

## BOARD OF DIRECTORS

|  |  |
|--|--|
| /s/Dennis F. Beardslee<br>Dennis F. Beardslee<br>Date: February 18, 2016 | /s/Edward H. Owlett, III<br>Edward H. Owlett, III<br>Date: February 18, 2016 |
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|  |  |
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| /s/Jan E. Fisher<br>Jan E. Fisher<br>Date: February 18, 2016 | /s/J. Bradley Scovill<br>J. Bradley Scovill<br>Date: February 18, 2016 |
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| /s/R. Bruce Haner<br>R. Bruce Haner<br>Date: February 18, 2016 | /s/Leonard Simpson<br>Leonard Simpson<br>Date: February 18, 2016 |
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| /s/Susan E. Hartley<br>Susan E. Hartley<br>Date: February 18, 2016 | /s/James E. Towner<br>James E. Towner<br>Date: February 18, 2016 |
|--|--|

|                         |                         |
|-------------------------|-------------------------|
| /s/Leo F. Lambert       | /s/Ann M. Tyler         |
| Leo F. Lambert          | Ann M. Tyler            |
| Date: February 18, 2016 | Date: February 18, 2016 |

|                         |                         |
|-------------------------|-------------------------|
| /s/Terry L. Lehman      | /s/Frank G. Pellegrino  |
| Terry L. Lehman         | Frank G. Pellegrino     |
| Date: February 18, 2016 | Date: February 18, 2016 |