

CITIZENS & NORTHERN CORP  
Form 10-Q  
August 08, 2011

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011  
or

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

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

Commission file number: 000-16084

CITIZENS & NORTHERN CORPORATION  
(Exact name of Registrant as specified in its charter)  
PENNSYLVANIA 23-2451943  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

90-92 MAIN STREET, WELLSBORO, PA 16901  
(Address of principal executive offices) (Zip code)  
570-724-3411  
(Registrant's telephone number including area code)

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" 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

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

Common Stock (\$1.00 par value)

12,154,287 Shares Outstanding on August 2, 2011

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CITIZENS & NORTHERN CORPORATION

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## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

## PART 1 - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## CONSOLIDATED BALANCE SHEET (Unaudited)

(In Thousands Except Share Data)

|   | June 30,<br>2011    | December 31,<br>2010 |
|---|---------------------|----------------------|
| <b>ASSETS</b>   |                     |                      |
| Cash and due from banks:  |                     |                      |
| Noninterest-bearing   | \$ 15,187           | \$ 16,840            |
| Interest-bearing  | 34,205              | 29,461               |
| Total cash and cash equivalents   | 49,392              | 46,301               |
| Available-for-sale securities   | 464,214             | 443,956              |
| Loans held for sale   | 167                 | 5,247                |
| Loans receivable  | 713,936             | 730,411              |
| Allowance for loan losses   | (8,269 )            | (9,107 )             |
| Loans, net  | 705,667             | 721,304              |
| Bank-owned life insurance   | 22,076              | 21,822               |
| Accrued interest receivable   | 4,952               | 4,960                |
| Bank premises and equipment, net  | 21,844              | 22,636               |
| Foreclosed assets held for sale   | 1,665               | 537                  |
| Deferred tax asset, net   | 10,099              | 16,054               |
| Intangible asset - Core deposit intangibles   | 269                 | 326                  |
| Intangible asset - Goodwill   | 11,942              | 11,942               |
| Other assets  | 17,363              | 21,503               |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,309,650</b> | <b>\$ 1,316,588</b>  |
| <b>LIABILITIES</b>  |                     |                      |
| Deposits:   |                     |                      |
| Noninterest-bearing   | \$ 165,424          | \$ 158,767           |
| Interest-bearing  | 829,937             | 845,581              |
| Total deposits  | 995,361             | 1,004,348            |
| Short-term borrowings   | 20,343              | 18,413               |
| Long-term borrowings  | 133,182             | 148,495              |
| Accrued interest and other liabilities  | 7,071               | 6,388                |
| <b>TOTAL LIABILITIES</b>  | <b>1,155,957</b>    | <b>1,177,644</b>     |
| <b>STOCKHOLDERS' EQUITY</b>   |                     |                      |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2011 and 2010; issued 12,432,768 at June 30, 2011 and 12,408,212 at December 31, 2010 | 12,433              | 12,408               |
| Paid-in capital   | 67,086              | 66,648               |
| Retained earnings   | 73,902              | 65,920               |
| Treasury stock, at cost; 278,375 shares at June 30, 2011 and 254,614 shares at December 31, 2010  | (4,714 )            | (4,431 )             |
| Sub-total   | 148,707             | 140,545              |
| Accumulated other comprehensive income (loss):  |                     |                      |
| Unrealized gains (losses) on available-for-sale securities  | 5,299               | (1,351 )             |
| Defined benefit plans   | (313 )              | (250 )               |

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|   |             |              |
|---|-------------|--------------|
| Total accumulated other comprehensive income (loss) | 4,986       | (1,601 )     |
| TOTAL STOCKHOLDERS' EQUITY                          | 153,693     | 138,944      |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY            | \$1,309,650 | \$ 1,316,588 |

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

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## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

CONSOLIDATED STATEMENT OF OPERATIONS  
(In Thousands, Except Per Share Data) (Unaudited)

|   | 3 Months Ended                |                                  | Fiscal Year To Date                             |                                  |
|---|-------------------------------|----------------------------------|---|----------------------------------|
|   | June 30,<br>2011<br>(Current) | June 30,<br>2010<br>(Prior Year) | 6 Months Ended<br>June 30,<br>2011<br>(Current) | June 30,<br>2010<br>(Prior Year) |
| <b>INTEREST AND DIVIDEND INCOME</b>   |                               |                                  |   |                                  |
| Interest and fees on loans  | \$ 10,854                     | \$ 11,009                        | \$ 21,722                                       | \$ 21,959                        |
| Interest on balances with depository institutions                             | 16                            | 38                               | 32  | 76                               |
| Interest on loans to political subdivisions                                   | 372                           | 399                              | 747   | 797                              |
| Interest on trading securities  | 0                             | 0                                | 0   | 1                                |
| Income from available-for-sale and held-to-maturity securities:               |                               |                                  |   |                                  |
| Taxable   | 2,849                         | 2,699                            | 5,542   | 5,784                            |
| Tax-exempt  | 1,291                         | 1,184                            | 2,575   | 2,365                            |
| Dividends   | 61                            | 57                               | 123   | 137                              |
| Total interest and dividend income  | 15,443                        | 15,386                           | 30,741  | 31,119                           |
| <b>INTEREST EXPENSE</b>   |                               |                                  |   |                                  |
| Interest on deposits  | 2,267                         | 3,058                            | 4,835   | 6,215                            |
| Interest on short-term borrowings   | 8                             | 51                               | 14  | 151                              |
| Interest on long-term borrowings  | 1,353                         | 1,927                            | 2,795   | 3,930                            |
| Total interest expense  | 3,628                         | 5,036                            | 7,644   | 10,296                           |
| Net interest income   | 11,815                        | 10,350                           | 23,097  | 20,823                           |
| Provision (credit) for loan losses  | 31                            | 76                               | (161 )  | 283                              |
| Net interest income after provision (credit) for loan losses                  | 11,784                        | 10,274                           | 23,258  | 20,540                           |
| <b>OTHER INCOME</b>   |                               |                                  |   |                                  |
| Service charges on deposit accounts   | 1,225                         | 1,190                            | 2,356   | 2,283                            |
| Service charges and fees  | 207                           | 210                              | 425   | 403                              |
| Trust and financial management revenue  | 946                           | 830                              | 1,823   | 1,729                            |
| Interchange revenue from debit card transactions                              | 485                           | 423                              | 937   | 799                              |
| Net gains from sale of loans  | 155                           | 137                              | 414   | 203                              |
| Increase in cash surrender value of life insurance                            | 132                           | 119                              | 254   | 231                              |
| Insurance commissions, fees and premiums                                      | 58                            | 61                               | 126   | 121                              |
| Impairment loss on limited partnership investment                             | 0                             | 0                                | (948 )  | 0                                |
| Other operating income  | 465                           | 290                              | 841   | 1,039                            |
| Sub-total   | 3,673                         | 3,260                            | 6,228   | 6,808                            |
| Total other-than-temporary impairment losses on available-for-sale securities | 0                             | 0                                | 0   | (381 )                           |
| Portion of (gain) loss recognized in other comprehensive loss (before taxes)  | 0                             | (2 )                             | 0   | (52 )                            |
| Net impairment losses recognized in earnings                                  | 0                             | (2 )                             | 0   | (433 )                           |
| Realized gains on available-for-sale securities, net                          | 163                           | 321                              | 2,002   | 810                              |
| Net realized gains on available-for-sale securities                           | 163                           | 319                              | 2,002   | 377                              |
| Total other income  | 3,836                         | 3,579                            | 8,230   | 7,185                            |
| <b>OTHER EXPENSES</b>   |                               |                                  |   |                                  |
| Salaries and wages  | 3,469                         | 3,199                            | 6,870   | 6,277                            |
| Pensions and other employee benefits  | 1,018                         | 983                              | 2,324   | 1,922                            |
| Occupancy expense, net  | 665                           | 651                              | 1,397   | 1,350                            |
| Furniture and equipment expense   | 453                           | 542                              | 937   | 1,110                            |

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|  |                |                |                 |                 |
|--|----------------|----------------|-----------------|-----------------|
| FDIC Assessments                                       | 189            | 415            | 514             | 819             |
| Pennsylvania shares tax                                | 320            | 306            | 639             | 611             |
| Other operating expense                                | 1,680          | 1,607          | 3,376           | 3,611           |
| Total other expenses                                   | 7,794          | 7,703          | 16,057          | 15,700          |
| Income before income tax provision                     | 7,826          | 6,150          | 15,431          | 12,025          |
| Income tax provision                                   | 2,129          | 1,281          | 4,193           | 2,718           |
| Net income   | 5,697          | 4,869          | 11,238          | 9,307           |
| U.S Treasury preferred dividends                       | 0              | 372            | 0               | 745             |
| <b>NET INCOME AVAILABLE TO COMMON<br/>SHAREHOLDERS</b> | <b>\$5,697</b> | <b>\$4,497</b> | <b>\$11,238</b> | <b>\$ 8,562</b> |
| Net income per share – basic                           | \$0.47         | \$0.37         | \$0.92          | \$ 0.71         |
| Net income per share – diluted                         | \$0.47         | \$0.37         | \$0.92          | \$ 0.71         |

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

## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

| CONSOLIDATED STATEMENT OF CASH FLOWS<br>(In Thousands) (Unaudited)                | Six Months Ended June 30, |                  |
|---|---------------------------|------------------|
|   | 2011                      | 2010             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                           |                  |
| Net income  | \$ 11,238                 | \$ 9,307         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |                  |
| (Credit) provision for loan losses  | (161 )                    | 283              |
| Realized gains on available-for-sale securities, net                              | (2,002 )                  | (377 )           |
| Loss on sale of foreclosed assets, net  | 43                        | 36               |
| Depreciation expense  | 1,058                     | 1,209            |
| Gain on disposition of premises and equipment                                     | 0                         | (449 )           |
| Accretion and amortization on securities, net                                     | 753                       | 1,273            |
| Accretion and amortization on loans, deposits and borrowings, net                 | (18 )                     | (126 )           |
| Amortization of mortgage servicing rights   | 29                        | 0                |
| Impairment loss on limited partnership interest                                   | 948                       | 0                |
| Increase in cash surrender value of life insurance                                | (254 )                    | (231 )           |
| Stock-based compensation  | 351                       | 32               |
| Amortization of core deposit intangibles  | 57                        | 88               |
| Deferred income taxes   | 2,562                     | 440              |
| Gains on sales of mortgage loans, net   | (414 )                    | (203 )           |
| Origination of mortgage loans for sale  | (8,453 )                  | (12,830 )        |
| Proceeds from sales of mortgage loans   | 13,807                    | 13,513           |
| Net decrease in trading securities  | 0                         | 1,045            |
| Decrease in accrued interest receivable and other assets                          | 2,750                     | 3,371            |
| Increase (decrease) in accrued interest payable and other liabilities             | 507                       | (253 )           |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>22,801</b>             | <b>16,128</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                           |                  |
| Proceeds from maturity of held-to-maturity securities                             | 0                         | 300              |
| Proceeds from sales of available-for-sale securities                              | 16,615                    | 45,522           |
| Proceeds from calls and maturities of available-for-sale securities               | 54,054                    | 85,954           |
| Purchase of available-for-sale securities   | (79,627 )                 | (159,082 )       |
| Redemption of Federal Home Loan Bank of Pittsburgh stock                          | 796                       | 0                |
| Net decrease (increase) in loans  | 14,424                    | (3,202 )         |
| Purchase of premises and equipment  | (266 )                    | (335 )           |
| Proceeds from disposition of premises and equipment                               | 0                         | 100              |
| Purchase of investment in limited liability entity                                | (200 )                    | 0                |
| Return of principal on limited liability entity investments                       | 70                        | 23               |
| Proceeds from sale of foreclosed assets   | 230                       | 408              |
| <b>Net Cash Provided by (Used in) Investing Activities</b>                        | <b>6,096</b>              | <b>(30,312 )</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                           |                  |
| Net (decrease) increase in deposits   | (8,996 )                  | 41,746           |
| Net increase (decrease) in short-term borrowings                                  | 1,930                     | (11,097 )        |
| Repayments of long-term borrowings  | (15,313 )                 | (22,300 )        |
| Purchase of treasury stock  | (571 )                    | 0                |
| Sale of treasury stock  | 16                        | 0                |
| Tax benefit from compensation plans   | 31                        | 18               |
| US Treasury preferred dividends paid  | 0                         | (662 )           |
| Common dividends paid   | (2,903 )                  | (1,934 )         |



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|   |                  |                  |
|---|------------------|------------------|
| Net Cash (Used in) Provided by Financing Activities       | (25,806 )        | 5,771            |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>   | <b>3,091</b>     | <b>(8,413 )</b>  |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR              | 46,301           | 92,065           |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>           | <b>\$ 49,392</b> | <b>\$ 83,652</b> |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b> |                  |                  |
| Assets acquired through foreclosure of real estate loans  | \$ 1,401         | \$ 434           |
| Interest paid   | \$ 7,694         | \$ 10,566        |
| Income taxes paid   | \$ 400           | \$ 176           |

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

## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

## Consolidated Statement of Changes in Stockholders' Equity

Six Months Ended June 30, 2011 and 2010

(In Thousands Except Per Share Data)

| (Unaudited)   | Preferred<br>Stock | Common<br>Stock | Paid-in<br>Capital | Retained<br>Earnings | Accum. Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock | Total         |
|---|--------------------|-----------------|--------------------|----------------------|--|-------------------|---------------|
| <b>Six Months Ended<br/>June 30, 2011:</b>                                |                    |                 |                    |                      |  |                   |               |
| Balance, December<br>31, 2010   | \$ 0               | \$ 12,408       | \$ 66,648          | \$ 65,920            | \$ (1,601 )                                    | \$ (4,431 )       | \$ 138,944    |
| <b>Comprehensive<br/>income:</b>  |                    |                 |                    |                      |  |                   |               |
| Net income  |                    |                 |                    | 11,238               |  |                   | 11,238        |
| Unrealized gain on<br>securities, net of<br>reclassification and<br>tax   |                    |                 |                    |                      | 6,650  |                   | 6,650         |
| Other<br>comprehensive loss<br>related to defined<br>benefit plans        |                    |                 |                    |                      | (63 )  |                   | (63 )         |
| <b>Total<br/>comprehensive<br/>income</b>                                 |                    |                 |                    |                      |  |                   | <b>17,825</b> |
| Cash dividends<br>declared on common<br>stock, \$.27 per share            |                    |                 |                    | (3,287 )             |  |                   | (3,287 )      |
| Shares issued for<br>dividend<br>reinvestment plan                        |                    | 25              | 359                |                      |  |                   | 384           |
| Treasury stock<br>purchased   |                    |                 |                    |                      |  | (571 )            | (571 )        |
| Shares issued from<br>treasury related to<br>exercise of stock<br>options |                    |                 | (3 )               |                      |  | 19                | 16            |
| Restricted stock<br>granted   |                    |                 | (272 )             |                      |  | 272               | 0             |
| Forfeiture of<br>restricted stock   |                    |                 | 3                  |                      |  | (3 )              | 0             |
| Stock-based<br>compensation<br>expense                                    |                    |                 | 351                |                      |  |                   | 351           |
| Tax benefit from<br>employee benefit<br>plan                              |                    |                 |                    | 31                   |  |                   | 31            |
| Balance, June 30,<br>2011   | \$ 0               | \$ 12,433       | \$ 67,086          | \$ 73,902            | \$ 4,986                                       | \$ (4,714 )       | \$ 153,693    |

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| Six Months Ended<br>June 30, 2010:                             |           |           |           |           |           |             |            |
|--|-----------|-----------|-----------|-----------|-----------|-------------|------------|
| Balance, December 31, 2009                                     | \$ 25,749 | \$ 12,374 | \$ 66,726 | \$ 53,027 | \$ (891 ) | \$ (4,575 ) | \$ 152,410 |
| Comprehensive income:  |           |           |           |           |           |             |            |
| Net income   |           |           |           | 9,307     |           |             | 9,307      |
| Unrealized gain on securities, net of reclassification and tax |           |           |           |           | 2,206     |             | 2,206      |
| Other comprehensive income related to defined benefit plans    |           |           |           |           | 118       |             | 118        |
| Total comprehensive income                                     |           |           |           |           |           |             | 11,631     |
| Accretion of discount associated with                          |           |           |           |           |           |             |            |
| U.S. Treasury preferred stock                                  | 84        |           |           | (84 )     |           |             | 0          |
| Cash dividends on U.S. Treasury preferred stock                |           |           |           | (661 )    |           |             | (661 )     |
| Cash dividends declared on common stock, \$.17 per share       |           |           |           | (2,061 )  |           |             | (2,061 )   |
| Shares issued for dividend reinvestment plan                   |           | 10        | 116       |           |           |             | 126        |
| Restricted stock granted                                       |           |           | (159 )    |           |           | 159         | 0          |
| Forfeiture of restricted stock                                 |           |           | 15        |           |           | (15 )       | 0          |
| Stock-based compensation expense                               |           |           | 32        |           |           |             | 32         |
| Tax benefit from employee benefit plan                         |           |           |           | 18        |           |             | 18         |
| Balance, June 30, 2010   | \$ 25,833 | \$ 12,384 | \$ 66,730 | \$ 59,546 | \$ 1,433  | \$ (4,431 ) | \$ 161,495 |

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

## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

## Notes to Unaudited Consolidated Financial Statements

## 1. BASIS OF INTERIM PRESENTATION

The consolidated financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2010, is unaudited. Such information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations, cash flows and changes in stockholders' equity for the interim periods; however, the information does not include all disclosures required by accounting principles generally accepted in the United States of America ("U.S. GAAP") for a complete set of financial statements. Certain 2010 information has been reclassified for consistency with the 2011 presentation.

Operating results reported for the three-month and six-month periods ended June 30, 2011 might not be indicative of the results for the year ending December 31, 2011. The Corporation evaluates subsequent events through the date of filing with the Securities and Exchange Commission.

## 2. PER COMMON 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 Income<br>Available<br>to Common<br>Shareholders | Weighted-<br>Average<br>Common<br>Shares | Earnings<br>Per<br>Share |
|---|--|--|--------------------------|
| <b>Six Months Ended June 30, 2011</b>                                 |  |  |                          |
| Earnings per common share – basic                                     | \$ 11,238,000  | 12,176,027                               | \$ 0.92                  |
| Dilutive effect of potential common stock arising from stock options: |  |  |                          |
| Exercise of outstanding stock options                                 |  | 93,266                                   |                          |
| Hypothetical share repurchase at \$15.58                              |  | (90,140 )                                |                          |
| Earnings per common share - diluted                                   | \$ 11,238,000  | 12,179,153                               | \$ 0.92                  |
| <b>Six Months Ended June 30, 2010</b>                                 |  |  |                          |
| Earnings per common share – basic and diluted                         | \$ 8,562,000   | 12,119,358                               | \$ 0.71                  |
| <b>Quarter Ended June 30, 2011</b>                                    |  |  |                          |
| Earnings per common share – basic                                     | \$ 5,697,000   | 12,177,110                               | \$ 0.47                  |
| Dilutive effect of potential common stock arising from stock options: |  |  |                          |
| Exercise of outstanding stock options                                 |  | 92,449                                   |                          |
| Hypothetical share repurchase at \$15.58                              |  | (89,360 )                                |                          |
| Earnings per common share - diluted                                   | \$ 5,697,000   | 12,180,199                               | \$ 0.47                  |

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Quarter Ended June 30, 2010

|   |              |            |         |
|---|--------------|------------|---------|
| Earnings per common share – basic and diluted | \$ 4,497,000 | 12,125,072 | \$ 0.37 |
|---|--------------|------------|---------|

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## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

Stock options and a warrant that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 225,245 shares in the six-month period ended June 30, 2011, 454,900 shares in the six months ended June 30, 2010, 224,063 shares in the second quarter 2011 and 429,393 shares in the second quarter 2010.

## 3. COMPREHENSIVE INCOME

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

| (In Thousands)   | 3 Months Ended |         | 6 Months Ended |          |
|--|----------------|---------|----------------|----------|
|  | June 30,       |         | June 30,       |          |
|  | 2011           | 2010    | 2011           | 2010     |
| Net income   | \$5,697        | \$4,869 | \$11,238       | \$9,307  |
| Unrealized gains on available-for-sale securities:   |                |         |                |          |
| Unrealized holding gains on available-for-sale securities  | 5,949          | 3,966   | 12,074         | 3,724    |
| Reclassification adjustment for gains realized in income   | (163 )         | (319 )  | (2,002 )       | (377 )   |
| Other comprehensive gain before income tax   | 5,786          | 3,647   | 10,072         | 3,347    |
| Income tax related to other comprehensive gain   | 1,965          | 1,245   | 3,422          | 1,141    |
| Other comprehensive gain on available-for-sale securities  | 3,821          | 2,402   | 6,650          | 2,206    |
| Unfunded pension and postretirement obligations:   |                |         |                |          |
| Change in items from defined benefit plans included in accumulated other comprehensive income                              | (3 )           | (14 )   | (122 )         | 152      |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 14             | 13      | 27             | 27       |
| Other comprehensive gain (loss) before income tax  | 11             | (1 )    | (95 )          | 179      |
| Income tax related to other comprehensive gain (loss)  | 4              | 0       | (32 )          | 61       |
| Other comprehensive gain (loss) on unfunded retirement obligations   | 7              | (1 )    | (63 )          | 118      |
| Net other comprehensive gain   | 3,828          | 2,401   | 6,587          | 2,324    |
| Total comprehensive income   | \$9,525        | \$7,270 | \$17,825       | \$11,631 |

The Corporation recognized other comprehensive income of \$52,000 before income tax (\$34,000 after income tax) related to available-for-sale debt securities for which a portion of an other-than-temporary impairment (OTTI) loss was recognized in earnings in the six months ended June 30, 2010, including other comprehensive income of \$2,000 before income tax (\$1,000 after income tax) in the second quarter 2010.

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

The Corporation measures certain assets at fair value on a recurring basis. 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” (formerly Statement of Financial Accounting Standards No. 157) 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.

At June 30, 2011 and December 31, 2010, assets measured at fair value on a recurring basis and the valuation methods used are as follows:

| (In Thousands)   | Quoted Prices<br>in Active<br>Markets<br>(Level 1) | June 30, 2011<br>Market Values Based on:   |                                     | Total<br>Fair<br>Value |
|--|--|--|-------------------------------------|------------------------|
|  |  | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>                        |  |  |                                     |                        |
| Obligations of U.S. Government agencies                      | \$ 0   | \$34,076                                   | \$ 0                                | \$34,076               |
| <b>Obligations of states and political subdivisions:</b>     |  |  |                                     |                        |
| Tax-exempt   | 0  | 125,326                                    | 0                                   | 125,326                |
| Taxable  | 0  | 12,743                                     | 0                                   | 12,743                 |
| Mortgage-backed securities                                   | 0  | 116,302                                    | 0                                   | 116,302                |
| <b>Collateralized mortgage obligations,</b>                  |  |  |                                     |                        |
| Issued by U.S. Government agencies                           | 0  | 152,156                                    | 0                                   | 152,156                |
| Corporate bonds  | 0  | 1,010                                      | 0                                   | 1,010                  |
| Trust preferred securities issued by individual institutions | 0  | 8,123                                      | 0                                   | 8,123                  |
| <b>Collateralized debt obligations:</b>                      |  |  |                                     |                        |
| Pooled trust preferred securities - senior tranches          | 0  | 0  | 7,207                               | 7,207                  |
| Other collateralized debt obligations                        | 0  | 660  | 0                                   | 660                    |
| Total debt securities  | 0  | 450,396                                    | 7,207                               | 457,603                |
| Marketable equity securities                                 | 6,611  | 0  | 0                                   | 6,611                  |

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|  |          |           |          |           |
|--|----------|-----------|----------|-----------|
| Total available-for-sale securities                      | 6,611    | 450,396   | 7,207    | 464,214   |
| Servicing rights   | 0        | 0         | 315      | 315       |
| Total assets measured at fair value on a recurring basis | \$ 6,611 | \$450,396 | \$ 7,522 | \$464,529 |

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| (In Thousands)   | Quoted Prices<br>in Active<br>Markets<br>(Level 1) | December 31, 2010<br>Market Values Based on: |                                     |  | Total<br>Fair<br>Value |
|--|--|--|-------------------------------------|--|------------------------|
|  |  | Other<br>Observable<br>Inputs<br>(Level 2)   | Unobservable<br>Inputs<br>(Level 3) |  |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>                        |  |  |                                     |  |                        |
| Obligations of U.S. Government agencies                      | \$ 0   | \$44,247                                     | \$ 0                                |  | \$44,247               |
| <b>Obligations of states and political subdivisions:</b>     |  |  |                                     |  |                        |
| Tax-exempt   | 4,574  | 115,301                                      | 0                                   |  | 119,875                |
| Taxable  | 1,125  | 6,542  | 0                                   |  | 7,667                  |
| Mortgage-backed securities                                   | 0  | 118,386                                      | 0                                   |  | 118,386                |
| <b>Collateralized mortgage obligations,</b>                  |  |  |                                     |  |                        |
| Issued by U.S. Government agencies                           | 9,117  | 121,709                                      | 0                                   |  | 130,826                |
| Corporate bonds  | 0  | 1,027  | 0                                   |  | 1,027                  |
| Trust preferred securities issued by individual institutions | 0  | 7,838  | 0                                   |  | 7,838                  |
| <b>Collateralized debt obligations:</b>                      |  |  |                                     |  |                        |
| Pooled trust preferred securities - senior tranches          | 0  | 0  | 7,400                               |  | 7,400                  |
| Other collateralized debt obligations                        | 0  | 681  | 0                                   |  | 681                    |
| Total debt securities  | 14,816   | 415,731                                      | 7,400                               |  | 437,947                |
| Marketable equity securities                                 | 6,009  | 0  | 0                                   |  | 6,009                  |
| Total available-for-sale securities                          | 20,825   | 415,731                                      | 7,400                               |  | 443,956                |
| Servicing rights   | 0  | 0  | 204                                 |  | 204                    |
| Total assets measured at fair value on a recurring basis     | \$ 20,825  | \$415,731                                    | \$ 7,604                            |  | \$444,160              |

Debt securities with a fair value of \$14,816,000 at December 31, 2010 were transferred from Level 1 to Level 2 in the first quarter 2011 in the table above. These securities were purchased in the month of December 2010, and their fair values at December 31, 2010 were determined based on the Corporation's purchase prices. The fair values of these securities were determined at June 30, 2011 based on price estimates provided by an independent valuation service based on Level 2 inputs.

Management determined there have been few trades of pooled trust-preferred securities since the first half of 2008, except for a limited number of transactions that have taken place as a result of bankruptcies, forced liquidations or similar circumstances. Also, in management's judgment, there were no available quoted market prices in active markets for assets sufficiently similar to the Corporation's pooled trust-preferred securities to be reliable as observable inputs. Accordingly, in the third quarter of 2008, the Corporation changed its method of valuing pooled trust-preferred securities from a Level 2 methodology that had been used in prior periods, based on price quotes received from pricing services, to a Level 3 methodology, using discounted cash flows.

Management has calculated the fair value of the Corporation's senior tranche pooled trust-preferred security by applying a discount rate to the estimated cash flows. In the first two quarters of 2011, management's estimate of cash flows from the senior tranche security changed significantly from the estimates in previous quarters based on the level and timing of assumed prepayments that changed for some of the underlying issuers. Management used the cash flow estimates determined using the process described in Note 5 for evaluating pooled trust-preferred securities for other-than-temporary impairment (OTTI). Management used a discount rate considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the security. In establishing the

discount rate, management considered: (1) the implied discount rate as of the end of 2007, prior to the market for trust-preferred securities becoming inactive; (2) adjustment to the year-end 2007 discount rate for the change in the spread between indicative market rates over corresponding risk-free rates; and (3) an additional adjustment – an increase of 2% in the discount rate – for liquidity risk. Management considered the additional 2% increase in the discount rate necessary in order to give some consideration to price estimates based on trades made under distressed conditions, as reported by brokers and pricing services. Management’s estimate of cash flows and the discount rate used to calculate the fair value of the pooled trust-preferred security were based on sensitive assumptions, and market participants might use substantially different assumptions, which could result in calculations of a fair value that would be substantially different than the amount calculated by management.

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Following is a reconciliation of activity for available-for-sale securities measured at fair value based on significant unobservable information:

|   | 3 Months Ended                |                                  | Fiscal Year To Date                          |                      |
|---|-------------------------------|----------------------------------|--|----------------------|
|   | June 30,<br>2011<br>(Current) | June 30,<br>2010<br>(Prior Year) | 6 Months Ended June 30,<br>2011<br>(Current) | 2010<br>(Prior Year) |
| Balance, beginning of period                            | \$ 9,038                      | \$ 8,552                         | \$ 7,400                                     | \$ 9,114             |
| Accretion and amortization, net                         | (14 )                         | (37 )                            | (34 )  | (215 )               |
| Proceeds from sales and calls                           | (2,060 )                      | (524 )                           | (2,085 )                                     | (524 )               |
| Realized gains, net                                     | 50                            | 0                                | 75   | 0                    |
| Unrealized losses included in earnings                  | 0                             | (2 )                             | 0  | (423 )               |
| Unrealized gains included in other comprehensive income | 193                           | 251                              | 1,851  | 288                  |
| Balance, end of period                                  | \$ 7,207                      | \$ 8,240                         | \$ 7,207                                     | \$ 8,240             |

Unrealized losses included in earnings are from the Corporation's other-than-temporary impairment analysis of securities, as described in Note 5, and are included in net impairment losses recognized in earnings in the consolidated statement of operations.

Assets measured at fair value on a nonrecurring basis include impaired commercial loans, foreclosed real estate assets held for sale and servicing rights. All of the Corporation's impaired commercial loans for which a valuation allowance was necessary at June 30, 2011 and December 31, 2010 were valued based on the estimated amount of net proceeds from liquidation of real estate and other collateral, or based on the estimated present value of cash flows to be received. The Corporation considers the fair value of such impaired commercial loans to be based on unobservable inputs (Level 3), and the balance of impaired loans for which a valuation allowance was recorded, net of allowance for loan losses, was \$2,467,000 at June 30, 2011 and \$3,169,000 at December 31, 2010. Similarly, the carrying values of foreclosed real estate assets held for sale were based on unobservable inputs (Level 3), with a balance of \$1,665,000 at June 30, 2011 and \$537,000 at December 31, 2010.

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.

**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 sales price available under the Federal Home Loan Banks' MPF 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 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.

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**SERVICING RIGHTS** – The fair value of servicing rights is determined through a discounted cash flow valuation. Significant inputs include expected net servicing income, the discount rate and the expected life of the underlying loans.

**DEPOSITS** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable on demand at June 30, 2011 and December 31, 2010. The fair value of all other deposit categories 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)                | June 30, 2011   |            | December 31, 2010 |            |
|-------------------------------|-----------------|------------|-------------------|------------|
|                               | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets:</b>      |                 |            |                   |            |
| Cash and cash equivalents     | \$ 49,392       | \$ 49,392  | \$ 46,301         | \$ 46,301  |
| Available-for-sale securities | 464,214         | 464,214    | 443,956           | 443,956    |
| Restricted equity securities  | 7,491           | 7,491      | 8,286             | 8,286      |
| Loans held for sale           | 167             | 167        | 5,247             | 5,249      |
| Loans, net                    | 705,667         | 710,476    | 721,304           | 728,744    |
| Accrued interest receivable   | 4,952           | 4,952      | 4,960             | 4,960      |
| Servicing rights              | 315             | 315        | 204               | 204        |
| <b>Financial liabilities:</b> |                 |            |                   |            |
| Deposits                      | 995,361         | 1,000,260  | 1,004,348         | 1,012,247  |
| Short-term borrowings         | 20,343          | 20,085     | 18,413            | 18,240     |
| Long-term borrowings          | 133,182         | 153,717    | 148,495           | 171,877    |
| Accrued interest payable      | 371             | 371        | 430               | 430        |

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## 5. SECURITIES

Amortized cost and fair value of available-for-sale securities at June 30, 2011 and December 31, 2010 are summarized as follows:

| (In Thousands)  | June 30, 2011  |                                |                                 |            |
|---|----------------|--------------------------------|---------------------------------|------------|
|   | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Obligations of U.S. Government agencies                                 | \$ 33,530      | \$ 546                         | \$ 0                            | \$ 34,076  |
| Obligations of states and political subdivisions:                       |                |                                |                                 |            |
| Tax-exempt  | 127,670        | 1,900                          | (4,244 )                        | 125,326    |
| Taxable   | 12,652         | 102                            | (11 )                           | 12,743     |
| Mortgage-backed securities  | 111,140        | 5,193                          | (31 )                           | 116,302    |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 149,946        | 2,309                          | (99 )                           | 152,156    |
| Corporate bonds   | 1,000          | 10                             | 0                               | 1,010      |
| Trust preferred securities issued by individual institutions            | 6,793          | 1,464                          | (134 )                          | 8,123      |
| Collateralized debt obligations:  |                |                                |                                 |            |
| Pooled trust preferred securities - senior tranches                     | 7,913          | 0                              | (706 )                          | 7,207      |
| Other collateralized debt obligations                                   | 660            | 0                              | 0                               | 660        |
| Total debt securities   | 451,304        | 11,524                         | (5,225 )                        | 457,603    |
| Marketable equity securities  | 4,883          | 1,795                          | (67 )                           | 6,611      |
| Total   | \$ 456,187     | \$ 13,319                      | \$ (5,292 )                     | \$ 464,214 |

| (In Thousands)  | December 31, 2010 |                                |                                 |            |
|---|-------------------|--------------------------------|---------------------------------|------------|
|   | Amortized Cost    | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Obligations of U.S. Government agencies                                 | \$ 44,005         | \$ 270                         | \$ (28 )                        | \$ 44,247  |
| Obligations of states and political subdivisions:                       |                   |                                |                                 |            |
| Tax-exempt  | 127,210           | 546                            | (7,882 )                        | 119,874    |
| Taxable   | 7,808             | 1                              | (141 )                          | 7,668      |
| Mortgage-backed securities  | 113,176           | 5,381                          | (171 )                          | 118,386    |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 131,040           | 869                            | (1,083 )                        | 130,826    |
| Corporate bonds   | 1,000             | 27                             | 0                               | 1,027      |
| Trust preferred securities issued by individual institutions            | 6,535             | 1,694                          | (391 )                          | 7,838      |

Collateralized debt obligations:

|   |            |           |              |            |
|---|------------|-----------|--------------|------------|
| Pooled trust preferred securities - senior tranches | 9,957      | 0         | (2,557 )     | 7,400      |
| Other collateralized debt obligations               | 681        | 0         | 0            | 681        |
| Total debt securities                               | 441,412    | 8,788     | (12,253 )    | 437,947    |
| Marketable equity securities                        | 4,589      | 1,496     | (76 )        | 6,009      |
| Total   | \$ 446,001 | \$ 10,284 | \$ (12,329 ) | \$ 443,956 |

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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 June 30, 2011 and December 31, 2010:

| June 30, 2011<br>(In Thousands)                                 | Less Than 12 Months |                   | 12 Months or More |                   | Total           |                   |
|---|---------------------|-------------------|-------------------|-------------------|-----------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value      | Unrealized Losses |
| <b>Obligations of states and political subdivisions:</b>        |                     |                   |                   |                   |                 |                   |
| Tax-exempt  | \$28,246            | \$(1,258 )        | \$30,986          | \$(2,986 )        | \$59,232        | \$(4,244 )        |
| Taxable   | 2,287               | (11 )             | 0                 | 0                 | 2,287           | (11 )             |
| Mortgage-backed securities                                      | 4,737               | (31 )             | 0                 | 0                 | 4,737           | (31 )             |
| <b>Collateralized mortgage obligations, Issued by U.S.</b>      |                     |                   |                   |                   |                 |                   |
| Government agencies   | 17,012              | (97 )             | 5,535             | (2 )              | 22,547          | (99 )             |
| Trust preferred securities issued by individual institutions    | 0                   | 0                 | 866               | (134 )            | 866             | (134 )            |
| <b>Collateralized debt obligations:</b>                         |                     |                   |                   |                   |                 |                   |
| <b>Pooled trust preferred securities</b>                        |                     |                   |                   |                   |                 |                   |
| - senior tranches   | 0                   | 0                 | 7,207             | (706 )            | 7,207           | (706 )            |
| <b>Total debt securities</b>                                    | <b>52,282</b>       | <b>(1,397 )</b>   | <b>44,594</b>     | <b>(3,828 )</b>   | <b>96,876</b>   | <b>(5,225 )</b>   |
| Marketable equity securities                                    | 510                 | (13 )             | 101               | (54 )             | 611             | (67 )             |
| <b>Total temporarily impaired available-for-sale securities</b> | <b>\$52,792</b>     | <b>\$(1,410 )</b> | <b>\$44,695</b>   | <b>\$(3,882 )</b> | <b>\$97,487</b> | <b>\$(5,292 )</b> |
| <br>  |                     |                   |                   |                   |                 |                   |
| December 31, 2010<br>(In Thousands)                             | Less Than 12 Months |                   | 12 Months or More |                   | Total           |                   |
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value      | Unrealized Losses |
| <b>Obligations of U.S. Government agencies</b>                  |                     |                   |                   |                   |                 |                   |
|   | \$10,230            | \$(28 )           | \$0               | \$0               | \$10,230        | \$(28 )           |
| <b>Obligations of states and political subdivisions:</b>        |                     |                   |                   |                   |                 |                   |
| Tax-exempt  | 53,119              | (2,533 )          | 28,622            | (5,349 )          | 81,741          | (7,882 )          |
| Taxable   | 6,542               | (141 )            | 0                 | 0                 | 6,542           | (141 )            |
| Mortgage-backed securities                                      | 13,141              | (171 )            | 0                 | 0                 | 13,141          | (171 )            |
| <b>Collateralized mortgage obligations, Issued by U.S.</b>      |                     |                   |                   |                   |                 |                   |
| Government agencies   | 56,257              | (1,083 )          | 0                 | 0                 | 56,257          | (1,083 )          |
| Trust preferred securities issued by individual institutions    | 0                   | 0                 | 5,825             | (391 )            | 5,825           | (391 )            |
| <b>Collateralized debt obligations:</b>                         |                     |                   |                   |                   |                 |                   |
| <b>Pooled trust preferred securities</b>                        |                     |                   |                   |                   |                 |                   |
| - senior tranches   | 0                   | 0                 | 7,400             | (2,557 )          | 7,400           | (2,557 )          |
| <b>Total debt securities</b>                                    | <b>139,289</b>      | <b>(3,956 )</b>   | <b>41,847</b>     | <b>(8,297 )</b>   | <b>181,136</b>  | <b>(12,253 )</b>  |
| Marketable equity securities                                    | 710                 | (76 )             | 0                 | 0                 | 710             | (76 )             |



Total temporarily impaired available-for-sale securities \$139,999 \$(4,032 ) \$41,847 \$(8,297 ) \$181,846 \$(12,329 )

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)                                     | 3 Months Ended   |                  | 6 months ended   |                  |
|--|------------------|------------------|------------------|------------------|
|  | June 30,<br>2011 | June 30,<br>2010 | June 30,<br>2011 | June 30,<br>2010 |
| Gross realized gains                               | \$ 169           | \$ 327           | \$ 2,009         | \$ 818           |
| Gross realized losses                              | (6 )             | (8 )             | (7 )             | (441 )           |
| Net realized gains                                 | \$ 163           | \$ 319           | \$ 2,002         | \$ 377           |
| Income tax provision related to net realized gains | \$ 55            | \$ 108           | \$ 681           | \$ 128           |

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The maturities of available-for-sale debt securities at June 30, 2011 are summarized as follows:

| (In Thousands)                         | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
| Due in one year or less                | \$ 7,732          | \$ 9,155      |
| Due after one year through five years  | 50,559            | 51,303        |
| Due after five years through ten years | 76,489            | 77,383        |
| Due after ten years                    | 316,524           | 319,762       |
| Total                                  | \$ 451,304        | \$ 457,603    |

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)   | 3 Months Ended   |                  | 6 Months Ended   |                  |
|--|------------------|------------------|------------------|------------------|
|  | June 30,<br>2011 | June 30,<br>2010 | June 30,<br>2011 | June 30,<br>2010 |
| Trust preferred securities issued by individual institutions | \$ 0             | \$ 0             | \$ 0             | \$ (320 )        |
| Pooled trust preferred securities - mezzanine tranches       | 0                | (2 )             | 0                | (103 )           |
| Marketable equity securities (bank stocks)                   | 0                | 0                | 0                | (10 )            |
| Net impairment losses recognized in earnings                 | \$ 0             | \$ (2 )          | \$ 0             | \$ (433 )        |

A summary of information management considered in evaluating debt and equity securities for OTTI at June 30, 2011 is provided below.

#### Debt Securities

At June 30, 2011, 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 June 30, 2011 to be temporary.

The credit rating agencies have withdrawn their ratings on numerous municipal bonds held by the Corporation. At June 30, 2011, the total amortized cost basis of municipal bonds with no external credit ratings was \$24,868,000, with an aggregate unrealized loss of \$2,370,000. At the time of purchase, each of these bonds was considered investment grade and had been rated by at least one credit rating agency. The bonds for which the ratings were removed were almost all insured by an entity that has reported significant financial problems and declines in its regulatory capital ratios. However, the insurance remains in effect on the bonds, and none of the affected municipal bonds has failed to

make a scheduled interest payment.

At June 30, 2011, the Corporation held one municipal bond with an external credit rating below investment grade. The bond had an amortized cost basis of \$1,128,000, with an unrealized gain of \$60,000. At the time of purchase, this bond held a rating of "A" from an external credit rating agency and was considered investment grade. During the second quarter 2011, the external credit rating agency downgraded the bond's rating to "BB", which is considered to be below investment grade, citing extended delays in the issuer's publication of financial statements. The affected municipal bond has continued to make scheduled interest payments.

## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

The following table provides information related to trust preferred securities issued by individual institutions as of June 30, 2011:

(In Thousands)

| Name of Issuer                     | Issuer's Parent Company       | Amortized Cost | Fair Value | Unrealized Gain (Loss) | Cumulative Realized Credit Losses | Moody's/<br>S&P/<br>Fitch<br>Credit<br>Ratings |
|------------------------------------|-------------------------------|----------------|------------|------------------------|-----------------------------------|--|
| Astoria Capital Trust I            | Astoria Financial Corporation | \$ 5,203       | \$ 5,277   | \$ 74                  | \$ 0                              | Baa3/BB-/BB-                                   |
| Carolina First Mortgage Loan Trust | The Toronto-Dominion Bank     | \$ 590         | \$ 1,980   | 1,390                  | (1,769 )                          | NR   |
| Patriot Capital Trust I            | Susquehanna Bancshares, Inc.  | \$ 1,000       | \$ 866     | (134 )                 | 0                                 | NR   |
| Total                              |                               | \$ 6,793       | \$ 8,123   | \$ 1,330               | \$ (1,769 )                       |  |

NR = not rated.

Management assesses each of the trust preferred securities issued by individual institutions for the possibility of OTTI by reviewing financial information that is publicly available. Neither Astoria Financial Corporation nor Susquehanna Bancshares, Inc. has deferred or defaulted on payments associated with the Corporation's securities.

The Corporation recognized OTTI charges in 2009 and 2010 related to the Carolina First Mortgage Loan Trust security. In the fourth quarter 2010, The Toronto-Dominion Bank acquired The South Financial Group, Inc., the parent company of Carolina First. After the acquisition, The Toronto-Dominion Bank made a payment for the full amount of previously deferred interest and resumed quarterly payments on the security. The Corporation recognized a material change in the expected cash flows in the fourth quarter 2010. The Corporation recorded \$160,000 in accretion income during the second quarter 2011 and accretion income totaling \$272,000 in the first six months of 2011. Management expects to record accretion income to offset the previous OTTI charges over the security's remaining life, through May 2012.

Pooled trust-preferred securities are very long-term (usually 30-year maturity) instruments, mainly issued by banks. The Corporation's investments in pooled trust-preferred securities are each made up of companies with geographic and size diversification. Almost all of the Corporation's pooled trust-preferred securities are composed of debt issued by banking companies, with lesser amounts issued by insurance companies. Some of the issuers of trust-preferred securities that are included in the Corporation's pooled investments have elected to defer payment of interest on these obligations (trust-preferred securities typically permit deferral of quarterly interest payments for up to five years), and some issuers have defaulted.

Management evaluated pooled trust-preferred securities for OTTI by estimating the cash flows expected to be received from each security, taking into account estimated levels of deferrals and defaults by the underlying issuers. In determining cash flows, management assumed all issuers currently deferring or in default would make no future payments, and assigned estimated future default levels for the remaining issuers in each security based on financial strength ratings assigned by a national ratings service. Management calculated the present value of each security based on the current book yield, adjusted for future changes in 3-month LIBOR (which is the index rate on the Corporation's adjustable-rate pooled trust-preferred securities) based on the applicable forward curve. Management's estimates of cash flows used to evaluate other-than-temporary impairment of pooled trust-preferred

securities were based on sensitive assumptions regarding the timing and amounts of defaults that may occur, and changes in those assumptions could produce different conclusions for each security.

During the first quarter 2011, management sold the Corporation's holding of the mezzanine tranche of MMCAPS Funding I, Ltd. The security was sold for aggregate pretax proceeds of \$1,485,000, which was recorded as a gain on the sale of securities in the first quarter.

## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

The following table provides detailed information related to pooled trust preferred securities – mezzanine tranches held as of June 30, 2011:

| Description                         | Amortized Cost | Fair Value | Unrealized Gain | Cumulative OTTI |
|-------------------------------------|----------------|------------|-----------------|-----------------|
| U.S. Capital Funding II, Ltd. (B-1) | \$ 0           | \$ 0       | \$ 0            | \$ (1,992 )     |
| U.S. Capital Funding II, Ltd. (B-2) | 0              | 0          | 0               | (2,973 )        |
| ALESCO Preferred Funding IX, Ltd.   | 0              | 0          | 0               | (2,988 )        |
| Total                               | \$ 0           | \$ 0       | \$ 0            | \$ (7,953 )     |

As of June 30, 2011, the Corporation’s investment in a senior tranche security (the senior tranche of MMCAPS Funding I, Ltd.) had an investment grade rating. The senior tranche security, with an amortized cost of \$7,913,000, has been subjected to impairment analysis based on estimated cash flows (using the process described above), and management has determined that impairment was temporary as of June 30, 2011. The table that follows provides additional information related to the senior tranche of MMCAPS Funding I, Ltd.:

## MMCAPS Funding I, Ltd. - Senior Tranche

|  |           |
|--|-----------|
| Number of Banks Currently Performing   | 16        |
| Moody's/Fitch Credit Ratings   | A3/BBB(1) |
| Actual Deferrals and Defaults as % of Outstanding Collateral                 | 32.3 %    |
| Expected Additional Net Deferrals and Defaults as % of Performing Collateral | 23.9 %    |
| Excess Subordination as % of Performing Collateral                           | 28.9 %    |

(1) Ratings information is as of June 30, 2011. Fitch has the senior tranche of MMCAPS Funding I, Ltd. on negative outlook.

In the table above, “Excess Subordination as % of Performing Collateral” (Excess Subordination Ratio) was calculated as follows: (Total face value of performing collateral – Face value of all outstanding note balances not subordinate to our investment)/Total face value of performing collateral.

The Excess Subordination Ratio measures the extent to which there may be tranches within the pooled trust preferred structure available to absorb credit losses before the Corporation’s security would be impacted. The positive Excess Subordination Ratio signifies there is some support from subordinate tranches available to absorb losses before the Corporation’s investment would be impacted.

The Corporation separates OTTI related to the trust-preferred securities into (a) the amount of the total impairment related to credit loss, which is recognized in the statement of earnings, and (b) the amount of the total impairment related to all other factors, which is recognized in other comprehensive income. The Corporation measures the credit loss component of OTTI based on the difference between: (1) the present value of estimated cash flows, at the book yield in effect prior to recognition of any OTTI, as of the most recent balance sheet date, and (2) the present value of estimated cash flows as of the previous quarter-end balance sheet date based on management’s cash flow assumptions at that time.

The Corporation recorded no OTTI losses related to pooled trust-preferred securities in the three-month or six-month periods ended June 30, 2011. The Corporation’s pre-tax loss from pooled trust-preferred securities in the three months

ended June 30, 2010 amounted to \$2,000, with a pre-tax gain included in other comprehensive income of \$2,000. Total OTTI from pooled trust-preferred securities in the six months ended June 30, 2010 amounted to \$51,000, including a pre-tax loss reflected in earnings of \$103,000, with a pre-tax other comprehensive gain of \$52,000 included in other comprehensive income.

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A roll-forward of the credit losses from securities for which a portion of OTTI has been recognized in other comprehensive income is as follows:

| (In Thousands)  | 3 Months Ended   |                  | 6 Months Ended   |                  |
|---|------------------|------------------|------------------|------------------|
|   | June 30,<br>2011 | June 30,<br>2010 | June 30,<br>2011 | June 30,<br>2010 |
| Balance of credit losses on debt securities for which a portion of OTTI was recognized in other comprehensive income, beginning of period   | \$0              | \$(5,831 )       | \$0              | \$(10,695 )      |
| Reduction for securities losses realized during the period  | 0                | 5,833            | 0                | 10,798           |
| Additional credit loss for which an OTTI was previously recognized when the Corporation does not intend to sell the security and it is not more likely than not the Corporation will be required to sell the security before recovery of its amortized cost basis | 0                | (2 )             | 0                | (103 )           |
| Balance of credit losses on debt securities for which a portion of OTTI was recognized in other comprehensive income, end of period   | \$0              | \$0              | \$0              | \$0              |

The line item labeled “Reduction for securities losses realized during the period” in the table immediately above includes OTTI write-downs associated with securities the Corporation continues to hold, but which have been deemed worthless.

## Equity Securities

The Corporation’s marketable equity securities at June 30, 2011 and December 31, 2010 consisted exclusively of stocks of banking companies. The Corporation recorded no OTTI losses related to bank stocks in the three-month or six-month periods ended June 30, 2011. The Corporation recorded no OTTI losses related to bank stocks in the second quarter 2010 but recorded OTTI totaling \$10,000 in the first six months of 2010. Management’s decision to record OTTI losses on bank stocks in 2010 was based on a combination of: (1) significant market depreciation in market prices in the first quarter 2009 (with some improvement subsequent to June 30, 2009), and (2) management’s intent to sell some of the stocks to generate capital losses, which could be carried back and offset against capital gains generated in previous years to realize tax refunds. At June 30, 2011, management did not intend to sell impaired bank stocks, and based on the intent to hold the securities for the foreseeable future and other factors specific to the securities, has determined that none of the Corporation’s bank stock holdings at June 30, 2011 were other than temporarily impaired.

During the three months ended June 30, 2011, the Corporation realized a gain of \$89,000 from the sale of a bank stock for which OTTI had been previously recognized. Realized gains from sales of bank stocks totaled \$91,000 in the six months ended June 30, 2011 including \$89,000 of realized gains from sales of stocks for which OTTI had been previously recognized. Realized gains from sales of bank stocks totaled \$134,000 in the three months ended June 30, 2010 including \$42,000 of realized gains from sales of stocks for which OTTI had been previously recognized. Realized gains from sales of bank stocks totaled \$483,000 in the six months ended June 30, 2010 including \$326,000 of realized gains from sales of stocks for which OTTI had been previously recognized.



C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 12 regional Federal Home Loan Banks. As a member, C&N Bank is required to purchase and maintain stock in FHLB-Pittsburgh. There is no active market for FHLB-Pittsburgh stock, and it must ordinarily be redeemed by FHLB-Pittsburgh in order to be liquidated. C&N Bank's investment in FHLB-Pittsburgh stock, included in Other Assets in the consolidated balance sheet, was \$7,361,000 at June 30, 2011 and \$8,156,000 at December 31, 2010. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at June 30, 2011 and December 31, 2010. In making this determination, management concluded that recovery of total outstanding par value, which equals the carrying value, is expected. The decision was based on review of financial information that FHLB-Pittsburgh has made publicly available.

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## 6. LOANS

The loans receivable portfolio is segmented into consumer mortgage, commercial and consumer loans. The consumer 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 outstanding at June 30, 2011 and December 31, 2010 are summarized as follows:

## Summary of Loans by Type

| (In Thousands)                            | June 30,<br>2011 | % of<br>Total |   | Dec. 31,<br>2010 | % of<br>Total |   |
|---|------------------|---------------|---|------------------|---------------|---|
| <b>Consumer mortgage:</b>                 |                  |               |   |                  |               |   |
| Residential mortgage loans - first liens  | \$ 334,300       | 46.82         | % | \$ 333,012       | 45.59         | % |
| Residential mortgage loans - junior liens | 30,214           | 4.23          | % | 31,590           | 4.32          | % |
| Home equity lines of credit               | 28,544           | 4.00          | % | 26,853           | 3.68          | % |
| 1-4 Family residential construction       | 8,574            | 1.20          | % | 14,379           | 1.97          | % |
| Total consumer mortgage                   | 401,632          | 56.26         | % | 405,834          | 55.56         | % |
| <b>Commercial:</b>                        |                  |               |   |                  |               |   |
| Commercial loans secured by real estate   | 157,282          | 22.03         | % | 167,094          | 22.88         | % |
| Commercial and industrial                 | 59,791           | 8.37          | % | 59,005           | 8.08          | % |
| Political subdivisions                    | 34,675           | 4.86          | % | 36,480           | 4.99          | % |
| Commercial construction                   | 24,726           | 3.46          | % | 24,004           | 3.29          | % |
| Loans secured by farmland                 | 10,927           | 1.53          | % | 11,353           | 1.55          | % |
| Multi-family (5 or more) residential      | 7,514            | 1.05          | % | 7,781            | 1.07          | % |
| Agricultural loans                        | 3,182            | 0.45          | % | 3,472            | 0.48          | % |
| Other commercial loans                    | 576              | 0.08          | % | 392              | 0.05          | % |
| Total commercial                          | 298,673          | 41.83         | % | 309,581          | 42.38         | % |
| Consumer                                  | 13,631           | 1.91          | % | 14,996           | 2.05          | % |
| Total                                     | 713,936          | 100.00        | % | 730,411          | 100.00        | % |
| Less: allowance for loan losses           | (8,269 )         |               |   | (9,107 )         |               |   |
| Loans, net                                | \$ 705,667       |               |   | \$ 721,304       |               |   |

The Corporation grants loans to individuals as well as commercial and tax-exempt entities. Commercial, residential and personal loans are made to customers geographically concentrated in the Pennsylvania and New York counties that comprise the market serviced by Citizens & Northern Bank. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. There is no concentration of loans to borrowers engaged in similar businesses or activities that exceed 10% of total loans at either June 30, 2011 or December 31, 2010.

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio,

current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. In the process of evaluating the loan portfolio, management also considers the Corporation's exposure to losses from unfunded loan commitments. As of June 30, 2011 and December 31, 2010, management determined that no allowance for credit losses related to unfunded loan commitments was required.

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Transactions within the allowance for loan losses, summarized by segment and class, for the year to date and the most recent quarter were as follows:

| (In Thousands)                            | December 31,<br>2010<br>Balance | Charge-<br>offs | Recoveries   | Provision<br>(Credit) | June 30,<br>2011<br>Balance |
|---|---------------------------------|-----------------|--------------|-----------------------|-----------------------------|
| <b>Allowance for Loan Losses:</b>         |                                 |                 |              |                       |                             |
| <b>Consumer mortgage:</b>                 |                                 |                 |              |                       |                             |
| Residential mortgage loans - first liens  | \$ 2,745                        | \$(28 )         | \$0          | \$333                 | \$3,050                     |
| Residential mortgage loans - junior liens | 334                             | (51 )           | 0            | 10                    | 293                         |
| Home equity lines of credit               | 218                             | 0               | 0            | 2                     | 220                         |
| 1-4 Family residential construction       | 208                             | 0               | 0            | (141 )                | 67                          |
| <b>Total consumer mortgage</b>            | <b>3,505</b>                    | <b>(79 )</b>    | <b>0</b>     | <b>204</b>            | <b>3,630</b>                |
| <b>Commercial:</b>                        |                                 |                 |              |                       |                             |
| Commercial loans secured by real estate   | 3,314                           | (535 )          | 0            | (277 )                | 2,502                       |
| Commercial and industrial                 | 862                             | (199 )          | 177          | 68                    | 908                         |
| Political subdivisions                    | 0                               | 0               | 0            | 0                     | 0                           |
| Commercial construction                   | 590                             | 0               | 0            | (309 )                | 281                         |
| Loans secured by farmland                 | 139                             | 0               | 0            | (5 )                  | 134                         |
| Multi-family (5 or more) residential      | 63                              | 0               | 0            | 12                    | 75                          |
| Agricultural loans                        | 32                              | 0               | 0            | (3 )                  | 29                          |
| Other commercial loans                    | 0                               | 0               | 0            | 5                     | 5                           |
| <b>Total commercial</b>                   | <b>5,000</b>                    | <b>(734 )</b>   | <b>177</b>   | <b>(509 )</b>         | <b>3,934</b>                |
| Consumer                                  | 289                             | (84 )           | 43           | 27                    | 275                         |
| Unallocated                               | 313                             |                 |              | 117                   | 430                         |
| <b>Total Allowance for Loan Losses</b>    | <b>\$ 9,107</b>                 | <b>\$(897 )</b> | <b>\$220</b> | <b>\$(161 )</b>       | <b>\$8,269</b>              |

| (In Thousands)                            | March 31,<br>2011<br>Balance | Charge-<br>offs | Recoveries | Provision<br>(Credit) | June 30,<br>2011<br>Balance |
|---|------------------------------|-----------------|------------|-----------------------|-----------------------------|
| <b>Allowance for Loan Losses:</b>         |                              |                 |            |                       |                             |
| <b>Consumer mortgage:</b>                 |                              |                 |            |                       |                             |
| Residential mortgage loans - first liens  | \$3,150                      | \$(27 )         | \$0        | \$(73 )               | \$3,050                     |
| Residential mortgage loans - junior liens | 305                          | 0               | 0          | (12 )                 | 293                         |
| Home equity lines of credit               | 212                          | 0               | 0          | 8                     | 220                         |
| 1-4 Family residential construction       | 62                           | 0               | 0          | 5                     | 67                          |
| <b>Total consumer mortgage</b>            | <b>3,729</b>                 | <b>(27 )</b>    | <b>0</b>   | <b>(72 )</b>          | <b>3,630</b>                |
| <b>Commercial:</b>                        |                              |                 |            |                       |                             |
| Commercial loans secured by real estate   | 3,118                        | (535 )          | 0          | (81 )                 | 2,502                       |
| Commercial and industrial                 | 842                          | (199 )          | 176        | 89                    | 908                         |
| Political subdivisions                    | 0                            | 0               | 0          | 0                     | 0                           |
| Commercial construction                   | 271                          | 0               | 0          | 10                    | 281                         |
| Loans secured by farmland                 | 142                          | 0               | 0          | (8 )                  | 134                         |
| Multi-family (5 or more) residential      | 77                           | 0               | 0          | (2 )                  | 75                          |
| Agricultural loans                        | 29                           | 0               | 0          | 0                     | 29                          |
| Other commercial loans                    | 8                            | 0               | 0          | (3 )                  | 5                           |
| <b>Total commercial</b>                   | <b>4,487</b>                 | <b>(734 )</b>   | <b>176</b> | <b>5</b>              | <b>3,934</b>                |

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|                                 |         |        |   |       |      |         |
|---------------------------------|---------|--------|---|-------|------|---------|
| Consumer                        | 275     | (39    | ) | 16    | 23   | 275     |
| Unallocated                     | 355     |        |   |       | 75   | 430     |
| Total Allowance for Loan Losses | \$8,846 | \$(800 | ) | \$192 | \$31 | \$8,269 |

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## CITIZENS &amp; NORTHERN CORPORATION – FORM 10-Q

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

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

The following tables summarize the aggregate credit quality classification of outstanding loans by risk rating as of both June 30, 2011 and December 31, 2010:

June 30, 2011:

| (In Thousands)                            | Pass             | Special<br>Mention | Substandard     | Doubtful       | Total            |
|---|------------------|--------------------|-----------------|----------------|------------------|
| <b>Consumer mortgage:</b>                 |                  |                    |                 |                |                  |
| Residential mortgage loans - first liens  | \$318,969        | \$2,573            | \$12,548        | \$210          | \$334,300        |
| Residential mortgage loans - junior liens | 28,606           | 632                | 968             | 8              | 30,214           |
| Home equity lines of credit               | 27,890           | 309                | 345             | 0              | 28,544           |
| 1-4 Family residential construction       | 8,574            | 0                  | 0               | 0              | 8,574            |
| Total consumer mortgage                   | 384,039          | 3,514              | 13,861          | 218            | 401,632          |
| <b>Commercial:</b>                        |                  |                    |                 |                |                  |
| Commercial loans secured by real estate   | 142,026          | 9,006              | 5,077           | 1,173          | 157,282          |
| Commercial and industrial                 | 47,634           | 7,220              | 4,632           | 305            | 59,791           |
| Political subdivisions                    | 34,548           | 127                | 0               | 0              | 34,675           |
| Commercial construction                   | 22,854           | 241                | 1,631           | 0              | 24,726           |
| Loans secured by farmland                 | 7,513            | 2,406              | 970             | 38             | 10,927           |
| Multi-family (5 or more) residential      | 7,498            | 0                  | 16              | 0              | 7,514            |
| Agricultural loans                        | 2,929            | 209                | 44              | 0              | 3,182            |
| Other commercial loans                    | 576              | 0                  | 0               | 0              | 576              |
| Total commercial                          | 265,578          | 19,209             | 12,370          | 1,516          | 298,673          |
| Consumer                                  | 13,395           | 27                 | 208             | 1              | 13,631           |
| <b>Totals</b>                             | <b>\$663,012</b> | <b>\$22,750</b>    | <b>\$26,439</b> | <b>\$1,735</b> | <b>\$713,936</b> |



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December 31, 2010:

| (In Thousands)                            | Pass             | Special<br>Mention | Substandard     | Doubtful       | Total            |
|---|------------------|--------------------|-----------------|----------------|------------------|
| <b>Consumer mortgage:</b>                 |                  |                    |                 |                |                  |
| Residential mortgage loans - first liens  | \$318,813        | \$2,197            | \$ 11,778       | \$224          | \$333,012        |
| Residential mortgage loans - junior liens | 30,072           | 551                | 959             | 8              | 31,590           |
| Home equity lines of credit               | 26,569           | 32                 | 252             | 0              | 26,853           |
| 1-4 Family residential construction       | 13,582           | 0                  | 797             | 0              | 14,379           |
| Total consumer mortgage                   | 389,036          | 2,780              | 13,786          | 232            | 405,834          |
| <b>Commercial:</b>                        |                  |                    |                 |                |                  |
| Commercial loans secured by real estate   | 152,157          | 6,671              | 6,472           | 1,794          | 167,094          |
| Commercial and industrial                 | 45,779           | 8,235              | 4,533           | 458            | 59,005           |
| Political subdivisions                    | 36,480           | 0                  | 0               | 70             | 36,480           |
| Commercial construction                   | 22,430           | 314                | 1,260           | 0              | 24,004           |
| Loans secured by farmland                 | 8,877            | 1,248              | 1,188           | 40             | 11,353           |
| Multi-family (5 or more) residential      | 7,781            | 0                  | 0               | 0              | 7,781            |
| Agricultural loans                        | 3,219            | 209                | 44              | 0              | 3,472            |
| Other commercial loans                    | 260              | 132                | 0               | 0              | 392              |
| Total commercial                          | 276,983          | 16,809             | 13,497          | 2,292          | 309,581          |
| Consumer                                  | 14,696           | 33                 | 265             | 2              | 14,996           |
| <b>Totals</b>                             | <b>\$680,715</b> | <b>\$19,622</b>    | <b>\$27,548</b> | <b>\$2,526</b> | <b>\$730,411</b> |

The general component of the allowance for loan losses 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 three-year average historical net charge-off rates, adjusted for qualitative factors. Qualitative risk factors (described in the following paragraph) are evaluated for the impact on each of the three distinct segments (consumer 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 consumer mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation's commercial segment loans (approximately 68% at June 30, 2011) is secured by real estate, and accordingly, the Corporation's risk for the commercial segment is significantly affected by commercial real estate values. The consumer segment includes a wide mix of loans for different purposes, primarily secured loans, including loans secured by motor vehicles, manufactured housing and other types of collateral.



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

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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, 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 “Collective-ly Evaluated” column in the tables summarizing the allowance and associated loan balances as of June 30, 2011 and December 31, 2010.

The following tables present a summary of loan balances and the related allowance for loan losses summarized by portfolio segment and class for each impairment method used as of June 30, 2011 and December 31, 2010:

| June 30, 2011<br>(In Thousands)           | Individually<br>Evaluated | Collectively<br>Evaluated | Totals            |
|---|---------------------------|---------------------------|-------------------|
| <b>Loans:</b>                             |                           |                           |                   |
| <b>Consumer mortgage:</b>                 |                           |                           |                   |
| Residential mortgage loans - first liens  | \$ 1,371                  | \$ 332,929                | \$ 334,300        |
| Residential mortgage loans - junior liens | 136                       | 30,078                    | 30,214            |
| Home equity lines of credit               | 0                         | 28,544                    | 28,544            |
| 1-4 Family residential construction       | 0                         | 8,574                     | 8,574             |
| Total consumer mortgage                   | 1,507                     | 400,125                   | 401,632           |
| <b>Commercial:</b>                        |                           |                           |                   |
| Commercial loans secured by real estate   | 1,860                     | 155,422                   | 157,282           |
| Commercial and industrial                 | 802                       | 58,989                    | 59,791            |
| Political subdivisions                    | 0                         | 34,675                    | 34,675            |
| Commercial construction                   | 978                       | 23,748                    | 24,726            |
| Loans secured by farmland                 | 930                       | 9,997                     | 10,927            |
| Multi-family (5 or more) residential      | 0                         | 7,514                     | 7,514             |
| Agricultural loans                        | 39                        | 3,143                     | 3,182             |
| Other commercial loans                    | 0                         | 576                       | 576               |
| Total commercial                          | 4,609                     | 294,064                   | 298,673           |
| Consumer                                  | 58                        | 13,573                    | 13,631            |
| <b>Total Loans</b>                        | <b>\$ 6,174</b>           | <b>\$ 707,762</b>         | <b>\$ 713,936</b> |

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| June 30, 2011<br>(In Thousands)           | Individually<br>Evaluated | Collectively<br>Evaluated | Totals            |
|---|---------------------------|---------------------------|-------------------|
| <b>Allowance for Loan Losses:</b>         |                           |                           |                   |
| <b>Consumer mortgage:</b>                 |                           |                           |                   |
| Residential mortgage loans - first liens  | \$ 455                    | \$ 2,595                  | \$ 3,050          |
| Residential mortgage loans - junior liens | 25                        | 268                       | 293               |
| Home equity lines of credit               | 0                         | 220                       | 220               |
| 1-4 Family residential construction       | 0                         | 67                        | 67                |
| <b>Total consumer mortgage</b>            | <b>480</b>                | <b>3,150</b>              | <b>3,630</b>      |
| <b>Commercial:</b>                        |                           |                           |                   |
| Commercial loans secured by real estate   | 650                       | 1,852                     | 2,502             |
| Commercial and industrial                 | 294                       | 614                       | 908               |
| Political subdivisions                    | 0                         | 0                         | 0                 |
| Commercial construction                   | 65                        | 216                       | 281               |
| Loans secured by farmland                 | 35                        | 99                        | 134               |
| Multi-family (5 or more) residential      | 0                         | 75                        | 75                |
| Agricultural loans                        | 0                         | 29                        | 29                |
| Other commercial loans                    | 0                         | 5                         | 5                 |
| <b>Total commercial</b>                   | <b>1,044</b>              | <b>2,890</b>              | <b>3,934</b>      |
| Consumer                                  | 58                        | 217                       | 275               |
| Unallocated                               |                           |                           | 430               |
| <b>Total Allowance for Loan Losses</b>    | <b>\$ 1,582</b>           | <b>\$ 6,257</b>           | <b>\$ 8,269</b>   |
| <br>                                      |                           |                           |                   |
| December 31, 2010<br>(In Thousands)       | Individually<br>Evaluated | Collectively<br>Evaluated | Totals            |
| <b>Loans:</b>                             |                           |                           |                   |
| <b>Consumer mortgage:</b>                 |                           |                           |                   |
| Residential mortgage loans - first liens  | \$ 442                    | \$ 332,570                | \$ 333,012        |
| Residential mortgage loans - junior liens | 239                       | 31,351                    | 31,590            |
| Home equity lines of credit               | 0                         | 26,853                    | 26,853            |
| 1-4 Family residential construction       | 994                       | 13,385                    | 14,379            |
| <b>Total consumer mortgage</b>            | <b>1,675</b>              | <b>404,159</b>            | <b>405,834</b>    |
| <b>Commercial:</b>                        |                           |                           |                   |
| Commercial loans secured by real estate   | 3,818                     | 163,276                   | 167,094           |
| Commercial and industrial                 | 931                       | 58,074                    | 59,005            |
| Political subdivisions                    | 0                         | 36,480                    | 36,480            |
| Commercial construction                   | 1,197                     | 22,807                    | 24,004            |
| Loans secured by farmland                 | 931                       | 10,422                    | 11,353            |
| Multi-family (5 or more) residential      | 0                         | 7,781                     | 7,781             |
| Agricultural loans                        | 39                        | 3,433                     | 3,472             |
| Other commercial loans                    | 0                         | 392                       | 392               |
| <b>Total commercial</b>                   | <b>6,916</b>              | <b>302,665</b>            | <b>309,581</b>    |
| Consumer                                  | 57                        | 14,939                    | 14,996            |
| <b>Total Loans</b>                        | <b>\$ 8,648</b>           | <b>\$ 721,763</b>         | <b>\$ 730,411</b> |



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| December 31, 2010<br>(In Thousands)       | Individually<br>Evaluated | Collectively<br>Evaluated | Totals          |
|---|---------------------------|---------------------------|-----------------|
| <b>Allowance for Loan Losses:</b>         |                           |                           |                 |
| <b>Consumer mortgage:</b>                 |                           |                           |                 |
| Residential mortgage loans - first liens  | \$ 98                     | \$ 2,647                  | \$ 2,745        |
| Residential mortgage loans - junior liens | 80                        | 254                       | 334             |
| Home equity lines of credit               | 0                         | 218                       | 218             |
| 1-4 Family residential construction       | 100                       | 108                       | 208             |
| Total consumer mortgage                   | 278                       | 3,227                     | 3,505           |
| <b>Commercial:</b>                        |                           |                           |                 |
| Commercial loans secured by real estate   | 1,335                     | 1,979                     | 3,314           |
| Commercial and industrial                 | 202                       | 660                       | 862             |
| Political subdivisions                    | 0                         | 0                         | 0               |
| Commercial construction                   | 380                       | 210                       | 590             |
| Loans secured by farmland                 | 36                        | 103                       | 139             |
| Multi-family (5 or more) residential      | 0                         | 63                        | 63              |
| Agricultural loans                        | 0                         | 32                        | 32              |
| Other commercial loans                    | 0                         | 0                         | 0               |
| Total commercial                          | 1,953                     | 3,047                     | 5,000           |
| Consumer                                  | 57                        | 232                       | 289             |
| Unallocated                               |                           |                           | 313             |
| <b>Total Allowance for Loan Losses</b>    | <b>\$ 2,288</b>           | <b>\$ 6,506</b>           | <b>\$ 9,107</b> |

Summary information related to impaired and restructured loans as of June 30, 2011 and December 31, 2010 is as follows:

| (In Thousands)                                    | As of<br>June 30<br>2011 | As of<br>Dec. 31<br>2010 |
|---|--------------------------|--------------------------|
| Impaired loans with a valuation allowance         | \$ 4,049                 | \$ 5,457                 |
| Impaired loans without a valuation allowance      | 2,125                    | 3,191                    |
| Total impaired loans                              | \$ 6,174                 | \$ 8,648                 |
| Valuation allowance related to impaired loans     | \$ 1,582                 | \$ 2,288                 |
| Restructured loans (troubled debt restructurings) | \$ 4,303                 | \$ 645                   |

The average investment in impaired loans was \$8,020,000 for the six months ended June 30, 2011 compared to \$6,142,000 for the year 2010. Interest income recognized on impaired loans was \$86,000 for the six months ended June 30, 2011 compared to \$204,000 for the year 2010 with all interest recognized on a cash basis.

Loans are placed on nonaccrual status for all classes of loans when, in the opinion of management, collection of interest is doubtful. Any unpaid interest previously accrued on those loans is reversed from income. Interest income is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on loans for which the risk of further loss is greater than remote are applied as a reduction of the loan principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total

contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments. Also, the amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

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

| (In Thousands)                            | June 30, 2011                           |                | December 31, 2010                       |                 |
|---|---|----------------|---|-----------------|
|   | Past Due<br>90+ Days<br>and<br>Accruing | Nonaccrual     | Past Due<br>90+ Days<br>and<br>Accruing | Nonaccrual      |
| <b>Consumer mortgage:</b>                 |   |                |   |                 |
| Residential mortgage loans - first liens  | \$334                                   | \$3,137        | \$571                                   | \$3,301         |
| Residential mortgage loans - junior liens | 21                                      | 114            | 0                                       | 218             |
| 1-4 Family residential construction       | 0                                       | 0              | 0                                       | 797             |
| <b>Total consumer mortgage</b>            | <b>355</b>                              | <b>3,251</b>   | <b>571</b>                              | <b>4,316</b>    |
| <b>Commercial:</b>                        |   |                |   |                 |
| Commercial loans secured by real estate   | 125                                     | 1,863          | 60                                      | 3,666           |
| Commercial and industrial                 | 18                                      | 480            | 0                                       | 611             |
| Commercial construction                   | 0                                       | 978            | 0                                       | 1,197           |
| Loans secured by farmland                 | 54                                      | 929            | 90                                      | 932             |
| Agricultural loans                        | 0                                       | 40             | 0                                       | 40              |
| <b>Total commercial</b>                   | <b>197</b>                              | <b>4,290</b>   | <b>150</b>                              | <b>6,446</b>    |
| <b>Consumer</b>                           | <b>9</b>                                | <b>45</b>      | <b>6</b>                                | <b>47</b>       |
| <b>Totals</b>                             | <b>\$561</b>                            | <b>\$7,586</b> | <b>\$727</b>                            | <b>\$10,809</b> |

The table below presents a summary of the contractual aging of loans as of June 30, 2011 and December 31, 2010:

| (In Thousands)                               | As of June 30, 2011                           |                           |                         |                |
|--|---|---------------------------|-------------------------|----------------|
|  | Current &<br>Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days | Total          |
| <b>Consumer mortgage:</b>                    |   |                           |                         |                |
| Residential mortgage loans - first liens     | \$ 327,859                                    | \$ 5,036                  | \$ 1,405                | \$ 334,300     |
| Residential mortgage loans - junior<br>liens | 29,761  | 377                       | 76                      | 30,214         |
| Home equity lines of credit                  | 28,344  | 200                       | 0                       | 28,544         |
| 1-4 Family residential construction          | 8,574   | 0                         | 0                       | 8,574          |
| <b>Total consumer mortgage</b>               | <b>394,538</b>                                | <b>5,613</b>              | <b>1,481</b>            | <b>401,632</b> |
| <b>Commercial:</b>                           |   |                           |                         |                |
| Commercial loans secured by real<br>estate   | 155,565                                       | 419                       | 1,298                   | 157,282        |
| Commercial and industrial                    | 58,846  | 821                       | 124                     | 59,791         |
| Political subdivisions                       | 34,675  | 0                         | 0                       | 34,675         |
| Commercial construction                      | 24,479  | 247                       | 0                       | 24,726         |
| Loans secured by farmland                    | 9,937   | 45                        | 945                     | 10,927         |
| Multi-family (5 or more) residential         | 7,505   | 9                         | 0                       | 7,514          |
| Agricultural loans                           | 3,142   | 0                         | 40                      | 3,182          |

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|                        |            |          |          |            |
|------------------------|------------|----------|----------|------------|
| Other commercial loans | 576        | 0        | 0        | 576        |
| Total commercial       | 294,725    | 1,541    | 2,407    | 298,673    |
| Consumer               | 13,492     | 130      | 9        | 13,631     |
| Totals                 | \$ 702,755 | \$ 7,284 | \$ 3,897 | \$ 713,936 |

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| (In Thousands)                               | As of December 31, 2010                       |                           |                         |                   |
|--|---|---------------------------|-------------------------|-------------------|
|  | Current &<br>Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days | Total             |
| <b>Consumer mortgage:</b>                    |   |                           |                         |                   |
| Residential mortgage loans - first liens     | \$ 325,567                                    | \$ 5,132                  | \$ 2,313                | \$ 333,012        |
| Residential mortgage loans - junior<br>liens | 30,997  | 436                       | 157                     | 31,590            |
| Home equity lines of credit                  | 26,744  | 109                       | 0                       | 26,853            |
| 1-4 Family residential construction          | 14,379  | 0                         | 0                       | 14,379            |
| <b>Total consumer mortgage</b>               | <b>397,687</b>                                | <b>5,677</b>              | <b>2,470</b>            | <b>405,834</b>    |
| <b>Commercial:</b>                           |   |                           |                         |                   |
| Commercial loans secured by real<br>estate   | 163,343                                       | 940                       | 2,811                   | 167,094           |
| Commercial and industrial                    | 58,474  | 319                       | 212                     | 59,005            |
| Political subdivisions                       | 36,480  | 0                         | 0                       | 36,480            |
| Commercial construction                      | 23,674  | 330                       | 0                       | 24,004            |
| Loans secured by farmland                    | 10,294  | 77                        | 982                     | 11,353            |
| Multi-family (5 or more) residential         | 7,769   | 12                        | 0                       | 7,781             |
| Agricultural loans                           | 3,422   | 10                        | 40                      | 3,472             |
| Other commercial loans                       | 77  | 315                       | 0                       | 392               |
| <b>Total commercial</b>                      | <b>303,533</b>                                | <b>2,003</b>              | <b>4,045</b>            | <b>309,581</b>    |
| <b>Consumer</b>                              | <b>14,686</b>                                 | <b>289</b>                | <b>21</b>               | <b>14,996</b>     |
| <b>Totals</b>                                | <b>\$ 715,906</b>                             | <b>\$ 7,969</b>           | <b>\$ 6,536</b>         | <b>\$ 730,411</b> |

Nonaccrual loans are included in the contractual aging immediately above and on the previous page. A summary of the contractual aging of nonaccrual loans at June 30, 2011 and December 31, 2010 is as follows:

| (In Thousands)                      | Current &                        |                           |                         |           |
|-------------------------------------|----------------------------------|---------------------------|-------------------------|-----------|
|                                     | Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days | Total     |
| June 30, 2011 Nonaccrual Totals     | \$ 3,577                         | \$ 673                    | \$ 3,336                | \$ 7,586  |
| December 31, 2010 Nonaccrual Totals | \$ 4,156                         | \$ 844                    | \$ 5,809                | \$ 10,809 |

## 7. 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. 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 June 30, 2011 and December 31, 2010, and will not affect the Corporation's future expenses. The Corporation uses a December 31 measurement date for the postretirement plan.

In 2007, the Corporation assumed the Citizens Trust Company Retirement Plan, a defined benefit pension plan for which benefit accruals and participation were frozen in 2002. Information related to the Citizens Trust Company Retirement Plan has been included in the table that follows. The Corporation uses a December 31 measurement date for this plan.

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

## Defined Benefit Plans

(In Thousands)

|   | Pension          |       | Postretirement   |        |
|---|------------------|-------|------------------|--------|
|   | Six Months Ended |       | Six Months Ended |        |
|   | June 30,         |       | June 30,         |        |
|   | 2011             | 2010  | 2011             | 2010   |
| Service cost                                  | \$ 0             | \$ 0  | \$ 42            | \$ 34  |
| Interest cost                                 | 37               | 34    | 46               | 45     |
| Expected return on plan assets                | (36 )            | (33 ) | 0                | 0      |
| Amortization of transition (asset) obligation | 0                | 0     | 18               | 18     |
| Amortization of prior service cost            | 0                | 0     | 7                | 7      |
| Recognized net actuarial loss                 | 2                | 2     | 0                | 0      |
| Net periodic benefit cost                     | \$ 3             | \$ 3  | \$ 113           | \$ 104 |

## Defined Benefit Plans

(In Thousands)

|   | Pension            |       | Postretirement     |       |
|---|--------------------|-------|--------------------|-------|
|   | Three Months Ended |       | Three Months Ended |       |
|   | June 30,           |       | June 30,           |       |
|   | 2011               | 2010  | 2011               | 2010  |
| Service cost                                  | \$ 0               | \$ 0  | \$ 21              | \$ 17 |
| Interest cost                                 | 19                 | 17    | 23                 | 23    |
| Expected return on plan assets                | (18 )              | (16 ) | 0                  | 0     |
| Amortization of transition (asset) obligation | 0                  | 0     | 9                  | 9     |
| Amortization of prior service cost            | 0                  | 0     | 4                  | 3     |
| Recognized net actuarial loss                 | 1                  | 1     | 0                  | 0     |
| Net periodic benefit cost                     | \$ 2               | \$ 2  | \$ 57              | \$ 52 |

In the first six months of 2011, the Corporation funded postretirement contributions totaling \$29,000, with estimated annual postretirement contributions of \$58,000 expected in 2011 for the full year. The Corporation made a contribution to the defined benefit pension plan of \$4,000 in the first quarter of 2011. Based upon the related actuarial reports, the Corporation has no required further contributions to the Citizens Trust Company Retirement Plan for the 2011 plan year; however, the Corporation may elect to make discretionary contributions later in 2011.

## 8. STOCK-BASED COMPENSATION PLANS

In January 2011, the Corporation granted options to purchase a total of 93,674 shares of common stock through its Stock Incentive and Independent Directors Stock Incentive Plans. The exercise price for the 2011 awards is \$15.06 per share, based on the market price as of the date of grant. In 2010, the Corporation made no awards of stock options. Stock option expense is recognized over the vesting period of each option. The Corporation expects total stock option expense for the year ending December 31, 2011 to be \$279,000, which is the amount recognized for the first six months of 2011.

The Corporation records stock option expense based on estimated fair value calculated using an option valuation model. In calculating the 2011 fair value, the Corporation utilized the Black-Scholes-Merton option-pricing

model. The calculated fair value of each option granted, and significant assumptions used in the calculations, are as follows:

|                                   | 2011    | 2010                    |
|-----------------------------------|---------|-------------------------|
| Fair value of each option granted | \$ 4.26 | Not applicable<br>(N/A) |
| Volatility                        | 37 %    | N/A                     |
| Expected option lives             | 8 Years | N/A                     |
| Risk-free interest rate           | 3.10 %  | N/A                     |
| Dividend yield                    | 3.86 %  | N/A                     |

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In calculating the estimated fair value of 2011 stock option awards, management based its estimates of volatility and dividend yield on the Corporation's experience over the immediately prior period of time consistent with the estimated lives of the options. The risk-free interest rate was based on the published yield of zero-coupon U.S. Treasury strips with an applicable maturity as of the grant dates. The 8-year expected option life was based on management's estimates of the average term for all options issued under both plans. Management assumed a 33% forfeiture rate for options granted under the Stock Incentive Plan, and a 0% forfeiture rate for the Directors Stock Incentive Plan. These estimated forfeiture rates were determined based on the Corporation's historical experience.

In January 2011, the Corporation awarded a total of 15,622 shares of restricted stock under the Stock Incentive and Independent Directors Stock Incentive Plans. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. For restricted stock awards granted under the Stock Incentive Plan, the Corporation must meet an annual targeted return on average equity ("ROAE") performance ratio, as defined, in order for participants to vest. Management has estimated restricted stock expense in the first six months of 2011 based on an assumption that the ROAE target for 2011 will be met. In the first quarter 2010, the Corporation awarded 9,125 shares of restricted stock to the Chief Executive Officer under the Stock Incentive Plan. This award provides that vesting will occur upon the earliest of (i) the third anniversary of the date of grant, (ii) death or disability or (iii) the occurrence of a change in control of the Corporation.

Total stock-based compensation expense is as follows:

| (In Thousands)   | Three Months Ended |                  | Six Months Ended |                  |
|------------------|--------------------|------------------|------------------|------------------|
|                  | June 30,<br>2011   | June 30,<br>2010 | June 30,<br>2011 | June 30,<br>2010 |
| Stock options    | \$ 123             | \$ 0             | \$ 279           | \$ 0             |
| Restricted stock | 36                 | 19               | 72               | 32               |
| Total            | \$ 159             | \$ 19            | \$ 351           | \$ 32            |

## 9. INCOME TAXES

The net deferred tax asset at June 30, 2011 and December 31, 2010 represents the following temporary difference components:

| (In Thousands)                          | June 30,<br>2011 | Dec. 31,<br>2010 |
|---|------------------|------------------|
| Deferred tax assets:                    |                  |                  |
| Unrealized holding losses on securities | \$ 0             | \$ 695           |
| Defined benefit plans - ASC 835         | 166              | 134              |
| Net realized losses on securities       | 3,436            | 5,755            |
| Allowance for loan losses               | 2,894            | 3,186            |
| Credit for alternative minimum tax paid | 4,814            | 3,287            |
| Net operating loss carryforwards        | 888              | 2,794            |
| General business credit carryforwards   | 815              | 815              |
| Other deferred tax assets               | 1,606            | 1,347            |
| Total deferred tax assets               | 14,619           | 18,013           |

Deferred tax liabilities:

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|  |           |           |
|--|-----------|-----------|
| Unrealized holding gains on securities | 2,730     | 0         |
| Bank premises and equipment            | 1,570     | 1,649     |
| Core deposit intangibles               | 94        | 114       |
| Other deferred tax liabilities         | 126       | 196       |
| Total deferred tax liabilities         | 4,520     | 1,959     |
| Deferred tax asset, net                | \$ 10,099 | \$ 16,054 |

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The deferred tax asset from realized losses on securities resulted primarily from OTTI charges for financial statement purposes that are not deductible for income tax reporting purposes through June 30, 2011. Of the total deferred tax asset from realized losses on securities, \$392,000 is from securities that, if the Corporation were to sell them, would be classified as capital losses for income tax reporting purposes.

The Corporation has available an estimated \$2,612,000 of total unused operating loss carryforwards at June 30, 2011, including a capital loss carryforward of \$369,000 expiring in 2015, and an estimated ordinary loss carryforward of \$2,243,000 almost all of which expires in 2030.

The Corporation has available, unused tax credits of \$815,000 at June 30, 2011 arising from investments in low income and elderly housing projects. These tax credits may provide future benefits and, if unused, would expire in varying annual amounts from 2024 through 2030.

The provision for income tax for the three and six month periods ended June 30, 2011 and 2010 is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The effective tax rates for the Corporation are as follows:

| (All amounts in thousands)         | Three Months Ended            |                                  | Fiscal Year To Date                            |                      |
|------------------------------------|-------------------------------|----------------------------------|--|----------------------|
|                                    | June 30,<br>2011<br>(Current) | June 30,<br>2010<br>(Prior Year) | Six Months Ended June 30,<br>2011<br>(Current) | 2010<br>(Prior Year) |
| Income before income tax provision | \$ 7,826                      | \$ 6,150                         | \$ 15,431                                      | \$ 12,025            |
| Income tax provision               | 2,129                         | 1,281                            | 4,193  | 2,718                |
| Effective tax rate                 | 27.20 %                       | 20.83 %                          | 27.17 %  | 22.60 %              |

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

The Corporation has no unrecognized tax benefits, nor pending examination issues related to tax positions taken in preparation of its income tax returns. The Corporation is no longer subject to examination by the Internal Revenue Service for years prior to 2006.

## 10. IMPAIRMENT OF LIMITED PARTNERSHIP INVESTMENT

In the first quarter 2011, the Corporation reported an impairment loss of \$948,000 related to an investment in a real estate limited partnership. This investment had been included in Other Assets in the consolidated balance sheet at December 31, 2010. In addition to the limited partnership investment, the Corporation has a loan receivable from the limited partnership of \$1,044,000 at June 30, 2011. Based on updated financial information, management prepared an estimated valuation based on cash flow analysis. That analysis showed the estimated return to the Corporation would be sufficient to repay the loan in full, but would not provide sufficient additional cash flow for return on the limited partnership investment. Accordingly, management made the decision to completely write-off the limited partnership investment in the first quarter 2011.

## 11. CONTINGENCIES

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



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12. RECENT ACCOUNTING PRONOUNCEMENTS

Since January 1, 2011, the FASB has issued additional FASB 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 April 2011, the FASB issued ASU 2011-02, Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The Update amends ASC Topic 310 to provide guidance in evaluating whether a restructuring constitutes a Troubled Debt Restructuring. The main provisions conclude that a creditor must separately conclude that both of the following exist – (1) the restructuring constitutes a concession, and (2) the debtor is experiencing financial difficulties. The amendments then provide guidance on a creditor's evaluation of each of the requirements for a Troubled Debt Restructuring. For public entities, the Update is effective for the first interim or annual period beginning on or after June 15, 2011, including retrospective application to the beginning of the annual period of adoption.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this Update will result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. The Update includes various amendments, including amendments that: (1) clarify FASB's intent about the application of existing fair value measurement and disclosure requirements, and (2) change some particular principles or requirements for measuring fair value or disclosing information about fair value measurements. Management believes there will be no changes in the Corporation's procedures for determining fair value measurements as a result of this Update, but expects to provide additional quantitative disclosures about unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy. The amendments in this ASU will be applied prospectively, and will be required for the Corporation beginning in the first quarter 2012.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220) – Presentation of Comprehensive Income. The intent of this standard is to increase the prominence of comprehensive income in the financial statements. This standard requires the components of comprehensive income be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single format would include the traditional income statement and the components of other comprehensive income, total other comprehensive income and total comprehensive income. In the two statement approach, the first statement would be the traditional income statement, which would be immediately followed by a separate statement which would include the components of other comprehensive income, total other comprehensive income and total comprehensive income. The amendments in this ASU will be applied retrospectively, and will be required for the Corporation beginning in the first quarter 2012.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

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

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

REFERENCES TO 2011 AND 2010

Unless otherwise noted, all references to “2011” in the following discussion of operating results are intended to mean the six months ended June 30, 2011, and similarly, references to “2010” relate to the six months ended June 30, 2010.

EARNINGS OVERVIEW

Net income available to common shareholders was \$5,697,000, or \$0.47 per share – basic and diluted in the second quarter 2011. Second quarter 2011 earnings were up from \$5,541,000, or \$0.46 per share – basic and \$0.45 per share – diluted in the first quarter 2011, and second quarter 2011 earnings were up 27% from net income per share of \$0.37 in the second quarter 2010. For the first six months of 2011, net income was \$11,238,000, or \$0.92 per share, up 29.6% from earnings per share of \$0.71 for the first six months of 2010.

Some of the more significant fluctuations in the components of earnings are as follows:

- Net interest income was \$11,815,000 in the second quarter 2011, up \$533,000 from the first quarter 2011 and up \$1,465,000 from the second quarter 2010. Year-to-date net interest income through June 30, 2011 totaled \$23,097,000, or \$2,274,000 (10.9%) higher than the total for the first six months of 2010. The improvement in net

interest income in 2011 has resulted from several factors, including ongoing reductions in cost of funds, reduction in outstanding borrowings and lower balances maintained in overnight investment with the Federal Reserve and other banks. Net interest income includes accretion of \$160,000 in the second quarter 2011, and \$272,000 in the first six months of 2011, from the offset of a previous write-down on a security.

- The provision for loan losses was \$31,000 in the second quarter 2011, as compared to a credit (reduction in expense) of (\$192,000) in the first quarter 2011 and a provision of \$76,000 in the second quarter 2010. For the first six months of 2011, the credit for loan losses was (\$161,000), as compared to a provision for loan losses of \$283,000 for the first six months of 2010. The favorable loan loss results in the first half of 2011 and 2010 reflect the Corporation's low levels of delinquencies and other loan-related credit problems, as compared to averages for comparable-sized peer banks.

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- Noninterest revenue was \$3,673,000 in the second quarter 2011, up from \$2,555,000 in the first quarter 2011 and \$3,260,000 in the second quarter 2010. For the six months ended June 30, 2011, noninterest revenue totaled \$6,228,000, down from \$6,808,000 in the first six months of 2010. The reduction in noninterest revenue in the first quarter 2011 resulted from an impairment loss of \$948,000 related to an investment in a real estate limited partnership. Excluding the impairment loss, noninterest revenue for the first six months of 2011 totaled \$7,176,000, or 5.4% higher than the corresponding 2010 amount.
- Gains from available-for-sale securities totaled \$163,000 in the second quarter 2011, down from \$1,839,000 in the first quarter 2011 and \$319,000 in the second quarter 2010. For the first six months of 2011, gains from available-for-sale securities were \$2,002,000, considerably higher than the total gains of \$377,000 for the first six months of 2010. In the first quarter 2011, the Corporation realized gains of \$1,510,000 from two pooled trust-preferred securities that had been written off in prior periods.
- Noninterest expense totaled \$7,794,000 in the second quarter 2011, down from \$8,263,000 in the first quarter 2011 and up 1.2% from total noninterest expense of \$7,703,000 in the second quarter 2010. The reduction in noninterest expense in the second quarter 2011 as compared to the immediate prior quarter resulted mainly from reductions in payroll taxes and employee benefit expense and FDIC assessments. Noninterest expense for the second quarter 2011 as compared to the second quarter 2010 reflected an increase of \$270,000 in salaries and wages, including \$122,000 from employee stock option compensation, and a decrease in FDIC assessments of \$226,000. In the six months ended June 30, 2011, total noninterest expense of \$16,057,000 was 2.3% higher than for the first six months of 2010. Total salaries and wages for the first six months of 2011 were \$593,000 higher than in 2010, including employee stock option compensation of \$244,000 and an increase of \$132,000 in estimated incentive compensation. Pensions and employee benefits expense was \$402,000 higher in the first six months of 2011 than in the corresponding period of 2010, including higher estimated self-insured employee health insurance expense. FDIC assessments were \$305,000 lower in the first six months of 2011 than in the first six months of 2010. Other operating expense was \$235,000 lower in the first six months of 2011 than in the corresponding period of 2010, including reductions in public company-related expenses, loan collection, other real estate expenses and office expenses.
- The provision for income taxes totaled \$2,129,000 or 27.2% of pre-tax income in the second quarter 2011, up from \$1,281,000 or 20.8% of pre-tax income in the second quarter 2010. For the six months ended June 30, 2011, the provision for income taxes was \$4,193,000 or 27.2% of pre-tax income, up from \$2,718,000 or 22.6% of pre-tax income in the first six months of 2010. The provision for income tax in the second quarter 2010 included a benefit (reduction in expense) of \$225,000 resulting from a reduction in a valuation reserve.
- In the third quarter 2010, the Corporation redeemed preferred stock that had previously been issued, and has had no preferred stock outstanding and no corresponding dividend costs in 2011. In 2010, earnings available for common shareholders were impacted by dividends paid on preferred stock, including \$372,000 in the second quarter 2010 and \$745,000 for the first six months of 2010.

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

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TABLE I - QUARTERLY FINANCIAL DATA  
(In Thousands)

|   | June 30,<br>2010 | Mar. 31,<br>2011 | Dec 31,<br>2010 | Sept. 30,<br>2010 | June 30,<br>2010 | Mar. 31,<br>2010 |
|---|------------------|------------------|-----------------|-------------------|------------------|------------------|
| Interest income   | \$15,443         | \$15,298         | \$15,500        | \$15,495          | \$15,386         | \$15,733         |
| Interest expense  | 3,628            | 4,016            | 4,310           | 4,639             | 5,036            | 5,260            |
| Net interest income   | 11,815           | 11,282           | 11,190          | 10,856            | 10,350           | 10,473           |
| Provision (credit) for loan losses                              | 31               | (192 )           | 719             | 189               | 76               | 207              |
| Net Interest income after<br>provision (credit) for loan losses | 11,784           | 11,474           | 10,471          | 10,667            | 10,274           | 10,266           |
| Other income  | 3,673            | 2,555            | 3,480           | 3,575             | 3,260            | 3,548            |
| Net gains on available-for-sale<br>securities                   | 163              | 1,839            | 64              | 388               | 319              | 58               |
| Other expenses  | 7,794            | 8,263            | 7,720           | 8,095             | 7,703            | 7,997            |
| Income before income tax<br>provision                           | 7,826            | 7,605            | 6,295           | 6,535             | 6,150            | 5,875            |
| Income tax provision  | 2,129            | 2,064            | 1,411           | 1,671             | 1,281            | 1,437            |
| Net income  | 5,697            | 5,541            | 4,884           | 4,864             | 4,869            | 4,438            |
| US Treasury preferred<br>dividends                              | 0                | 0                | 0               | 729               | 372              | 373              |
| Net income available to<br>common shareholders                  | \$5,697          | \$5,541          | \$4,884         | \$4,135           | \$4,497          | \$4,065          |
| Net income per common share –<br>basic                          | \$0.47           | \$0.46           | \$0.40          | \$0.34            | \$0.37           | \$0.34           |
| Net income per common share –<br>diluted                        | \$0.47           | \$0.45           | \$0.40          | \$0.34            | \$0.37           | \$0.34           |

## CRITICAL ACCOUNTING POLICIES

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

A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate and reasonable. Analytical information related to the Corporation's aggregate loans and the related allowance for loan losses is summarized by loan segment and classes of loans in Note 6 to the consolidated financial statements. Additional discussion of the Corporation's methodology for determining the allowance for loan losses is described 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 4 to the consolidated financial statements, management calculates the fair values of pooled trust-preferred securities by applying discount rates to estimated cash flows for each security. Management estimated the cash flows expected to be received from each security, taking into account estimated levels of deferrals and defaults by the underlying issuers, and used discount rates considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the securities. Management's estimates of cash flows and discount rates used to calculate fair values of pooled trust-preferred securities were based on sensitive assumptions, and use of different assumptions could result in calculations of fair values that would be substantially different than the amounts calculated by management.

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As described in Note 5 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. Also, management's estimates of cash flows used to evaluate OTTI of pooled trust-preferred securities are based on sensitive assumptions, and use of different assumptions could produce different conclusions for each security.

## NET INTEREST INCOME

The Corporation's primary source of operating income is net interest income, which is equal to the difference between the amounts of interest income and interest expense. Tables II, III and IV include information regarding the Corporation's net interest income for the three-month and six-month periods ended June 30, 2011 and June 30, 2010. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest income amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the related Tables.

## Six-Month Periods Ended June 30, 2011 and 2010

For the six-month periods, fully taxable equivalent net interest income was \$24,712,000 in 2011, \$2,373,000 (10.6%) higher than in 2010. As shown in Table IV, net changes in volume had the effect of increasing net interest income \$2,100,000 in 2011 compared to 2010, and interest rate changes had the effect of increasing net interest income \$273,000. The most significant components of the volume change in net interest income in 2011 were: an increase in interest income of \$863,000 attributable to growth in the balance of available-for-sale securities and a decrease in interest expense of \$1,026,000 attributable to a reduction in the balance of long-term borrowed funds. The most significant components of the rate change in net interest income in 2011 were: a decrease in interest income of \$788,000 attributable to lower rates earned on available-for-sale securities and a decrease in interest expense of \$1,195,000 due to lower rates paid on interest-bearing deposits. As presented in Table III, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.84% in 2011, as compared to 3.43% in 2010.

## INTEREST INCOME AND EARNING ASSETS

Interest income totaled \$32,356,000 in 2011, a decrease of 0.9% from 2010. Income from available-for-sale securities increased \$75,000 (0.8%), while interest and fees from loans decreased \$306,000, or 1.3%. As indicated in Table III, total average available-for-sale securities (at amortized cost) in 2011 increased to \$458,733,000, an increase of \$34,447,000, or 8.1% from 2010. During 2010 and 2011, the Corporation increased the size of its tax-exempt municipal security portfolio. Net growth in the taxable available-for-sale securities portfolio was primarily made up of U.S. Government agency collateralized mortgage obligations. The Corporation's yield on taxable securities fell in 2010 and 2011 primarily because of low market interest rates, including the effects of management's decision to limit purchases of taxable securities to investments that mature or are expected to repay a substantial portion of principal within approximately four years or less. The average rate of return on available-for-sale securities was 4.17% for 2011 and 4.48% in 2010.

The average balance of gross loans increased 0.1% to \$720,244,000 in 2011 from \$719,731,000 in 2010. In spite of the challenging economic environment, the Corporation has experienced growth in the average balance of commercial loans. This growth has been partially offset by modest contraction in the balance of the residential mortgage and consumer loan portfolios, primarily resulting from management's decision to sell a portion of newly originated residential mortgages on the secondary market. The Corporation's yield on loans fell as rates on new loans as well as existing, variable-rate loans have decreased. The average rate of return on loans was 6.39% in 2011 and 6.48% in 2010.

The average balance of interest-bearing due from banks decreased to \$30,561,000 in 2011 from \$66,605,000 in 2010. This has consisted primarily of balances held by the Federal Reserve. Although the rates of return on balances with the Federal Reserve are low, the Corporation has maintained relatively high levels of liquid assets in 2010 and 2011 (as opposed to increasing long-term, available-for-sale securities at higher yields) in order to maximize flexibility for dealing with possible fluctuations in cash requirements, and due to management's concern about the possibility of substantial increases in interest rates within the next few years. Also, in 2010, management maintained a portion of the balance with the Federal Reserve in anticipation of repurchasing the TARP Preferred Stock and Warrant. These repurchases were completed during the third quarter 2010.



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INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell \$2,652,000, or 25.8%, to \$7,644,000 in 2011 from \$10,296,000 in 2010. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 1.55% in 2011 from 2.01% in 2010.

Total average deposits (interest-bearing and noninterest-bearing) increased 6.0%, to \$1,002,444,000 in 2011 from \$945,797,000 in 2010. This increase came mainly in interest checking, savings accounts, and demand deposits; the increases were partially offset by a decrease in the average balance of certificates of deposit and Individual Retirement Accounts. Consistent with continuing low short-term market interest rates, the average rates incurred on deposit accounts have decreased significantly in 2011 as compared to 2010.

Variable-rate accounts comprised \$148,128,000 of the average balance in Individual Retirement Accounts in 2011 and \$151,086,000 in 2010. Prior to May 2011, substantially all of these accounts were paid interest at a rate that could change quarterly at management's discretion with a contractual floor of 3.00%. Effective in May 2011, the rate floor was removed and the rate paid was lowered to 1.50%, which was the rate in effect at June 30, 2011. As shown in Table III, the average rate on Individual Retirement Accounts decreased to 2.73% in 2011 from 3.09% in 2010.

Total average borrowed funds decreased \$67,098,000 to \$158,687,000 in 2011 from \$225,785,000 in 2010. During 2010 and 2011, the Corporation has paid off long-term borrowings as they matured using the cash flow received from loans, mortgage-backed securities, and growth in deposit balances. The average rate on borrowed funds was 3.57% in 2011, down from 3.64% in 2010.

Three-Month Periods Ended June 30, 2011 and 2010

Except as noted below, significant changes in the three-month results are consistent with the discussion of the six-month results provided in the previous section.

For the three-month periods, fully taxable equivalent net interest income was \$12,627,000 in 2011, \$1,515,000 (13.6%) higher than in 2010. As shown in Table IV, net changes in volume had the effect of increasing net interest income \$962,000 in 2011 compared to 2010, and interest rate changes had the effect of increasing net interest income \$553,000. As presented in Table III, the "Interest Rate Spread" was 3.92% in 2011, as compared to 3.35% in 2010.

Interest income totaled \$16,255,000 in 2011, an increase of 0.7% from 2010. Income from available-for-sale securities increased \$322,000, while interest and fees from loans decreased \$193,000, or 1.7%. As indicated in Table III, total average available-for-sale securities (at amortized cost) in 2011 increased to \$463,338,000, an increase of \$29,693,000, or 6.8% from 2010. The average rate of return on available-for-sale securities was 4.18% for 2011 and 4.17% in 2010. For the three-month period, the average balance of gross loans decreased 0.4% to \$716,481,000 in 2011 from \$719,204,000 in 2010. The average rate of return on loans was 6.39% in 2011 and 6.47% in 2010. The average balance of interest-bearing due from banks, mainly from balances held by the Federal Reserve, decreased to \$29,385,000 in 2011 from \$66,326,000 in 2010.

For the three-month period, interest expense fell \$1,408,000, or 28.0%, to \$3,628,000 in 2011 from \$5,036,000 in 2010. Total average deposits (interest-bearing and noninterest-bearing) increased 4.4%, to \$1,002,866,000 in 2011 from \$960,211,000 in 2010. Total average borrowed funds decreased \$63,571,000 to \$154,751,000 in 2011 from \$218,322,000 in 2010.



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TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE

| (In Thousands)                      | Three Months Ended |          | Increase/<br>(Decrease) | Six Months Ended |          | Increase/<br>(Decrease) |
|-------------------------------------|--------------------|----------|-------------------------|------------------|----------|-------------------------|
|                                     | June 30,<br>2011   | 2010     |                         | June 30,<br>2011 | 2010     |                         |
| <b>INTEREST INCOME</b>              |                    |          |                         |                  |          |                         |
| Available-for-sale securities:      |                    |          |                         |                  |          |                         |
| Taxable                             | \$2,910            | \$2,756  | \$154                   | \$5,665          | \$5,919  | \$(254)                 |
| Tax-exempt                          | 1,921              | 1,753    | 168                     | 3,826            | 3,497    | 329                     |
| Total available-for-sale securities | 4,831              | 4,509    | 322                     | 9,491            | 9,416    | 75                      |
| Held-to-maturity securities,        |                    |          |                         |                  |          |                         |
| Taxable                             | 0                  | 0        | 0                       | 0                | 2        | (2)                     |
| Trading securities                  | 0                  | 0        | 0                       | 0                | 2        | (2)                     |
| Interest-bearing due from banks     | 16                 | 38       | (22)                    | 32               | 76       | (44)                    |
| Federal funds sold                  | 0                  | 0        | 0                       | 0                | 0        | 0                       |
| Loans:                              |                    |          |                         |                  |          |                         |
| Taxable                             | 10,854             | 11,009   | (155)                   | 21,722           | 21,959   | (237)                   |
| Tax-exempt                          | 554                | 592      | (38)                    | 1,111            | 1,180    | (69)                    |
| Total loans                         | 11,408             | 11,601   | (193)                   | 22,833           | 23,139   | (306)                   |
| Total Interest Income               | 16,255             | 16,148   | 107                     | 32,356           | 32,635   | (279)                   |
| <b>INTEREST EXPENSE</b>             |                    |          |                         |                  |          |                         |
| Interest-bearing deposits:          |                    |          |                         |                  |          |                         |
| Interest checking                   | 117                | 227      | (110)                   | 247              | 434      | (187)                   |
| Money market                        | 140                | 231      | (91)                    | 291              | 480      | (189)                   |
| Savings                             | 48                 | 47       | 1                       | 104              | 91       | 13                      |
| Certificates of deposit             | 1,001              | 1,299    | (298)                   | 2,042            | 2,725    | (683)                   |
| Individual Retirement Accounts      | 960                | 1,252    | (292)                   | 2,149            | 2,482    | (333)                   |
| Other time deposits                 | 1                  | 2        | (1)                     | 2                | 3        | (1)                     |
| Total interest-bearing deposits     | 2,267              | 3,058    | (791)                   | 4,835            | 6,215    | (1,380)                 |
| Borrowed funds:                     |                    |          |                         |                  |          |                         |
| Short-term                          | 8                  | 51       | (43)                    | 14               | 151      | (137)                   |
| Long-term                           | 1,353              | 1,927    | (574)                   | 2,795            | 3,930    | (1,135)                 |
| Total borrowed funds                | 1,361              | 1,978    | (617)                   | 2,809            | 4,081    | (1,272)                 |
| Total Interest Expense              | 3,628              | 5,036    | (1,408)                 | 7,644            | 10,296   | (2,652)                 |
| Net Interest Income                 | \$12,627           | \$11,112 | \$1,515                 | \$24,712         | \$22,339 | \$2,373                 |

Note: Interest income from tax-exempt securities and loans has been adjusted to a fully tax-equivalent basis, using the Corporation's marginal federal income tax rate of 34%.

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Table III - Analysis of Average Daily Balances and Rates  
(Dollars in Thousands)

|   | 3 Months<br>Ended<br>6/30/2011 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 3 Months<br>Ended<br>6/30/2010 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 6 Months<br>Ended<br>6/30/2011 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% | 6 Months<br>Ended<br>6/30/2010 | Rate<br>of<br>Return/<br>Cost<br>of<br>Funds<br>% |
|---|--------------------------------|---|--------------------------------|---|--------------------------------|---|--------------------------------|---|
| <b>EARNING ASSETS</b>                             |                                |   |                                |   |                                |   |                                |   |
| Available-for-sale securities, at amortized cost: |                                |   |                                |   |                                |   |                                |   |
| Taxable   | \$ 335,289                     | 3.48 %  | \$ 324,555                     | 3.41 %  | \$ 331,219                     | 3.45 %  | \$ 315,809                     | 3.78 %  |
| Tax-exempt  | 128,049                        | 6.02 %  | 109,090                        | 6.45 %  | 127,514                        | 6.05 %  | 108,477                        | 6.50 %  |
| Total available-for-sale securities               | 463,338                        | 4.18 %  | 433,645                        | 4.17 %  | 458,733                        | 4.17 %  | 424,286                        | 4.48 %  |
| Held-to-maturity securities,                      |                                |   |                                |   |                                |   |                                |   |
| Taxable   | 0                              | 0.00 %  | 0                              | 0.00 %  | 0                              | 0.00 %  | 76                             | 5.27 %  |
| Trading securities                                | 0                              | 0.00 %  | 0                              | 0.00 %  | 0                              | 0.00 %  | 58                             | 6.99 %  |
| Interest-bearing due from banks                   |                                |   |                                |   |                                |   |                                |   |
| Federal funds sold                                | 29,385                         | 0.22 %  | 66,326                         | 0.23 %  | 30,561                         | 0.21 %  | 66,605                         | 0.23 %  |
| Loans:  |                                |   |                                |   |                                |   |                                |   |
| Taxable   | 681,675                        | 6.39 %  | 682,956                        | 6.47 %  | 685,305                        | 6.39 %  | 683,425                        | 6.48 %  |
| Tax-exempt  | 34,806                         | 6.38 %  | 36,248                         | 6.55 %  | 34,939                         | 6.41 %  | 36,306                         | 6.55 %  |
| Total loans                                       | 716,481                        | 6.39 %  | 719,204                        | 6.47 %  | 720,244                        | 6.39 %  | 719,731                        | 6.48 %  |
| Total Earning Assets                              | 1,209,204                      | 5.39 %  | 1,219,271                      | 5.31 %  | 1,209,538                      | 5.39 %  | 1,210,834                      | 5.44 %  |
| Cash  | 17,631                         |   | 17,807                         |   | 17,310                         |   | 17,367                         |   |
| Unrealized gain/loss on securities                |                                |   |                                |   |                                |   |                                |   |
| Allowance for loan losses                         | (8,938 )                       |   | (8,523 )                       |   | (9,069 )                       |   | (8,467 )                       |   |
| Bank premises and equipment                       |                                |   |                                |   |                                |   |                                |   |
| Intangible Asset - Core Deposit Intangible        | 287                            |   | 438                            |   | 301                            |   | 461                            |   |
| Intangible Asset - Goodwill                       |                                |   |                                |   |                                |   |                                |   |
| Other assets                                      | 11,942                         |   | 11,942                         |   | 11,942                         |   | 11,942                         |   |
| Total Assets                                      | \$ 1,314,394                   |   | \$ 1,344,043                   |   | \$ 1,313,482                   |   | \$ 1,335,267                   |   |

**INTEREST-BEARING LIABILITIES**

Interest-bearing deposits:

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|   |              |        |              |        |              |        |              |        |
|---|--------------|--------|--------------|--------|--------------|--------|--------------|--------|
| Interest checking   | \$ 166,795   | 0.28 % | \$ 144,439   | 0.63 % | \$ 165,146   | 0.30 % | \$ 135,826   | 0.64 % |
| Money market  | 207,266      | 0.27 % | 203,567      | 0.46 % | 205,363      | 0.29 % | 200,313      | 0.48 % |
| Savings   | 95,821       | 0.20 % | 75,720       | 0.25 % | 94,232       | 0.22 % | 73,662       | 0.25 % |
| Certificates of deposit   | 205,346      | 1.96 % | 226,352      | 2.30 % | 208,721      | 1.97 % | 231,622      | 2.37 % |
| Individual Retirement   |              |        |              |        |              |        |              |        |
| Accounts  | 156,611      | 2.46 % | 163,156      | 3.08 % | 158,880      | 2.73 % | 162,147      | 3.09 % |
| Other time deposits   | 1,350        | 0.30 % | 1,380        | 0.58 % | 1,154        | 0.35 % | 1,186        | 0.51 % |
| Total interest-bearing deposits                                 | 833,189      | 1.09 % | 814,614      | 1.51 % | 833,496      | 1.17 % | 804,756      | 1.56 % |
| Borrowed funds:   |              |        |              |        |              |        |              |        |
| Short-term  | 19,407       | 0.17 % | 30,478       | 0.67 % | 18,143       | 0.16 % | 33,815       | 0.90 % |
| Long-term   | 135,344      | 4.01 % | 187,844      | 4.11 % | 140,544      | 4.01 % | 191,970      | 4.13 % |
| Total borrowed funds  | 154,751      | 3.53 % | 218,322      | 3.63 % | 158,687      | 3.57 % | 225,785      | 3.64 % |
| Total Interest-bearing Liabilities                              | 987,940      | 1.47 % | 1,032,936    | 1.96 % | 992,183      | 1.55 % | 1,030,541    | 2.01 % |
| Demand deposits   | 169,677      |        | 145,597      |        | 168,948      |        | 141,041      |        |
| Other liabilities   | 6,998        |        | 7,244        |        | 6,731        |        | 7,354        |        |
| Total Liabilities   | 1,164,615    |        | 1,185,777    |        | 1,167,862    |        | 1,178,936    |        |
| Stockholders' equity, excluding other comprehensive income/loss | 146,267      |        | 157,946      |        | 144,172      |        | 156,430      |        |
| Other comprehensive income/loss                                 | 3,512        |        | 320          |        | 1,448        |        | (99 )        |        |
| Total Stockholders' Equity                                      | 149,779      |        | 158,266      |        | 145,620      |        | 156,331      |        |
| Total Liabilities and Stockholders' Equity                      | \$ 1,314,394 |        | \$ 1,344,043 |        | \$ 1,313,482 |        | \$ 1,335,267 |        |
| Interest Rate Spread  |              | 3.92 % |              | 3.35 % |              | 3.84 % |              | 3.43 % |
| Net Interest Income/Earning Assets                              |              | 4.19 % |              | 3.66 % |              | 4.12 % |              | 3.72 % |
| Total Deposits (Interest-bearing and Demand)                    | \$ 1,002,866 |        | \$ 960,211   |        | \$ 1,002,444 |        | \$ 945,797   |        |

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

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

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TABLE IV - ANALYSIS OF VOLUME AND RATE CHANGES

| (In Thousands)                      | 3 Months Ended 6/30/11 vs. 6/30/10 |                   |                 | 6 Months Ended 6/30/11 vs. 6/30/10 |                   |                 |
|-------------------------------------|------------------------------------|-------------------|-----------------|------------------------------------|-------------------|-----------------|
|                                     | Change in<br>Volume                | Change in<br>Rate | Total<br>Change | Change in<br>Volume                | Change in<br>Rate | Total<br>Change |
| <b>EARNING ASSETS</b>               |                                    |                   |                 |                                    |                   |                 |
| Available-for-sale securities:      |                                    |                   |                 |                                    |                   |                 |
| Taxable                             | \$82                               | \$72              | \$154           | \$280                              | \$(534)           | \$(254)         |
| Tax-exempt                          | 290                                | (122)             | 168             | 583                                | (254)             | 329             |
| Total available-for-sale securities | 372                                | (50)              | 322             | 863                                | (788)             | 75              |
| Held-to-maturity securities,        |                                    |                   |                 |                                    |                   |                 |
| Taxable                             | 0                                  | 0                 | 0               | (1)                                | (1)               | (2)             |
| Trading securities                  | 0                                  | 0                 | 0               | (1)                                | (1)               | (2)             |
| Interest-bearing due from banks     | (20)                               | (2)               | (22)            | (38)                               | (6)               | (44)            |
| Federal funds sold                  | 0                                  | 0                 | 0               | 0                                  | 0                 | 0               |
| Loans:                              |                                    |                   |                 |                                    |                   |                 |
| Taxable                             | (21)                               | (134)             | (155)           | 60                                 | (297)             | (237)           |
| Tax-exempt                          | (22)                               | (16)              | (38)            | (43)                               | (26)              | (69)            |
| Total loans                         | (43)                               | (150)             | (193)           | 17                                 | (323)             | (306)           |
| Total Interest Income               | 309                                | (202)             | 107             | 840                                | (1,119)           | (279)           |
| <b>INTEREST-BEARING LIABILITIES</b> |                                    |                   |                 |                                    |                   |                 |
| Interest-bearing deposits:          |                                    |                   |                 |                                    |                   |                 |
| Interest checking                   | 32                                 | (142)             | (110)           | 80                                 | (267)             | (187)           |
| Money market                        | 4                                  | (95)              | (91)            | 12                                 | (201)             | (189)           |
| Savings                             | 12                                 | (11)              | 1               | 24                                 | (11)              | 13              |
| Certificates of deposit             | (113)                              | (185)             | (298)           | (252)                              | (431)             | (683)           |
| Individual Retirement Accounts      | (49)                               | (243)             | (292)           | (49)                               | (284)             | (333)           |
| Other time deposits                 | 0                                  | (1)               | (1)             | 0                                  | (1)               | (1)             |
| Total interest-bearing deposits     | (114)                              | (677)             | (791)           | (185)                              | (1,195)           | (1,380)         |
| Borrowed funds:                     |                                    |                   |                 |                                    |                   |                 |
| Short-term                          | (13)                               | (30)              | (43)            | (49)                               | (88)              | (137)           |
| Long-term                           | (526)                              | (48)              | (574)           | (1,026)                            | (109)             | (1,135)         |
| Total borrowed funds                | (539)                              | (78)              | (617)           | (1,075)                            | (197)             | (1,272)         |
| Total Interest Expense              | (653)                              | (755)             | (1,408)         | (1,260)                            | (1,392)           | (2,652)         |
| Net Interest Income                 | \$962                              | \$553             | \$1,515         | \$2,100                            | \$273             | \$2,373         |

(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 34%.

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



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## RECOVERY ON IMPAIRED INVESTMENT SECURITY

In 2009, the Corporation recorded OTTI of \$3,209,000 on its holding of a trust preferred security issued by Carolina First Mortgage Loan Trust, a subsidiary of The South Financial Group, Inc., and the Corporation also ceased accruing interest income on the security. In January 2010, The South Financial Group, Inc. began deferring its interest payments on the security. In April 2010, the Corporation sold half of its investment in the security, and in the first quarter 2010 recorded OTTI of \$320,000 to further write down amortized cost based on the selling price of the April transaction.

In the fourth quarter 2010, The Toronto-Dominion Bank acquired The South Financial Group, Inc., made a payment for the full amount of previously deferred interest, and resumed quarterly payments on the security. The Corporation recognized a material change in the expected cash flows and began recording accretion income (included in interest income) to offset the previous OTTI charges as an adjustment to the security's yield over its remaining life. The estimated yield to maturity is 146.70%. The security has a face amount of \$2 million, matures in May 2012, and has an interest rate which adjusts quarterly based on 3-month LIBOR. The security had an amortized cost of \$590,000 and a fair value of \$1,980,000 at June 30, 2011.

The actual and estimated future amounts of accretion income from this security are as follows:

|                              | Accretion of<br>Prior OTTI |
|------------------------------|----------------------------|
| 4th Quarter 2010 (Actual)    | \$ 83                      |
| 1st Quarter 2011 (Actual)    | 111                        |
| 2nd Quarter 2011 (Actual)    | 160                        |
| 3rd Quarter 2011 (Estimated) | 229                        |
| 4th Quarter 2011 (Estimated) | 325                        |
| 1st Quarter 2012 (Estimated) | 457                        |
| 2nd Quarter 2012 (Estimated) | 398                        |
| Total                        | \$ 1,763                   |

TABLE V - COMPARISON OF NON-INTEREST INCOME

(In Thousands)

|  | Three Months Ended |                  | Six Months Ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | June 30,<br>2011   | June 30,<br>2010 | June 30,<br>2011 | June 30,<br>2010 |
| Service charges on deposit accounts                | \$ 1,225           | \$ 1,190         | \$ 2,356         | \$ 2,283         |
| Service charges and fees                           | 207                | 210              | 425              | 403              |
| Trust and financial management revenue             | 946                | 830              | 1,823            | 1,729            |
| Interchange revenue from debit card transactions   | 485                | 424              | 937              | 799              |
| Net gains from sales of loans                      | 155                | 137              | 414              | 203              |
| Increase in cash surrender value of life insurance | 132                | 119              | 254              | 231              |
| Insurance commissions, fees and premiums           | 58                 | 61               | 126              | 121              |
|  | 0                  | 0                | (948 )           | 0                |



Impairment loss on limited  
partnership investment

|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Brokerage revenue   | 229      | 107      | 352      | 216      |
| Net (loss) gain from other real estate  | (24 )    | 2        | (43 )    | (36 )    |
| Net gain from sale of premises and<br>equipment   | 0        | 1        | 0        | 449      |
| Other operating income  | 260      | 179      | 532      | 410      |
| Total other operating income, before<br>realized gains on available-for-sale<br>securities, net | \$ 3,673 | \$ 3,260 | \$ 6,228 | \$ 6,808 |

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NON-INTEREST INCOME - SIX MONTHS ENDED JUNE 30, 2011 AND 2010

Table V excludes realized gains (losses) on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table V decreased \$580,000 or 8.5%, in the first six months of 2011 compared to the first six months of 2010. Items of significance are as follows:

- In the first quarter 2011, the Corporation reported an impairment loss of \$948,000 related to an investment in a real estate limited partnership. This investment had been included in Other Assets in the consolidated balance sheet at December 31, 2010. In addition to the limited partnership investment, the Corporation has a loan receivable from the limited partnership of \$1,044,000 at June 30, 2011. Based on updated financial information, management prepared an estimated valuation based on cash flow analysis. That analysis showed the estimated return to the Corporation would be sufficient to repay the loan in full, but would not provide sufficient additional cash flow for return on the limited partnership investment. Accordingly, management made the decision to completely write-off the limited partnership investment in 2011.
- In 2010, net gains from sales of premises and equipment totaled \$449,000, including a first quarter gain of \$448,000 from the sale of a parcel adjacent to one of the bank operating locations. The sale proceeds included \$390,000 associated with long-term privileges within a municipal parking facility currently under construction.
  - Trust and financial management revenue was \$94,000, or 5.4%, higher in 2011 than in 2010. Assets under management in the first half of 2011 have been higher than in the corresponding period of 2010, including the impact of market value appreciation. Assets under management amounted to \$634,821,000 at June 30, 2011, up 13.7% from June 30, 2010.
- Interchange revenue from debit card transactions of \$937,000 in the first six months of 2011 is \$138,000, or 17.3%, higher than in the same period of 2010. The increased level of interchange fees reflects customers’ higher volume of debit card transactions. The Federal Reserve recently issued a final rule, effective October 1, 2011, which establishes maximum interchange rates that may be paid to large (as defined) financial institutions. The maximum rates established under the rule are approximately 45% lower than the average market rates paid to the Corporation throughout the last several years. Although the rule’s rate constraints do not directly apply to the Corporation (because the Corporation is not considered a large financial institution for this purpose), management believes interchange revenues could be reduced either because of lower volumes or because market conditions may dictate that smaller financial institutions receive rates similar to large financial institutions. Management is monitoring regulatory and market conditions associated with interchange processing, but cannot reasonably estimate the timing or amount of future changes in interchange revenues that may occur.
- Net gains from the sale of loans increased \$211,000 in 2011 compared to 2010. In 2010, management began to sell a significant amount of residential mortgage originations into the secondary market. The increase in the net gains from sales of loans is almost entirely associated with the Corporation’s participation in the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The increased volume of mortgage loans sold in the first six months of 2011 includes the impact of significant refinancing activity in the last several months of 2010. In 2011, new activity has been reduced from the last several months of 2010, as evidenced by the reduction in the outstanding balance of loans held for sale to \$167,000 at June 30, 2011 from \$5,247,000 at December 31, 2010.

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Brokerage revenue of \$352,000 in the first six months of 2011 was \$136,000 higher than in the same period of 2010. The increase in brokerage revenue includes the effects of sales of annuities to customers who had previously held variable rate Individual Retirement Accounts (deposits) with the Corporation. Changes in variable rate Individual Retirement Account deposits are discussed in more detail in the Net Interest Income section of Management's Discussion and Analysis.

- Other operating income of \$532,000 in the first six months of 2011 was \$122,000 higher than in the first six months of 2010. In 2011, this category included income of \$122,000 from a limited liability equity investment in an entity performing title insurance services throughout Pennsylvania. No similar income was recognized for the Corporation's investment in this entity in 2010.

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## NON-INTEREST INCOME – THREE MONTHS ENDED JUNE 30, 2011 AND 2010

Total noninterest income, excluding securities gains, amounted to \$3,673,000 in the second quarter 2011, which was \$413,000 (12.7%) higher than in the second quarter 2010. As reflected in Table V, the most significant increases were from: (1) brokerage revenue, which was up \$122,000, or 114.0%; (2) trust and financial management revenue, which was up \$116,000 or 14.0%; other operating income, which was up \$81,000, or 45.3%; and (4) interchange revenues, which increased \$61,000, or 14.4%. The trends related to these categories of noninterest income are discussed above in the comparisons of amounts for the six-month periods ended June 30, 2011 and 2010.

## TABLE VI - COMPARISON OF NON-INTEREST EXPENSE

| (In Thousands)                       | Three Months Ended |                  | Six Months Ended |                  |
|--------------------------------------|--------------------|------------------|------------------|------------------|
|                                      | June 30,<br>2011   | June 30,<br>2010 | June 30,<br>2011 | June 30,<br>2010 |
| Salaries and wages                   | \$ 3,469           | \$ 3,199         | \$ 6,870         | \$ 6,277         |
| Pensions and other employee benefits | 1,018              | 983              | 2,324            | 1,922            |
| Occupancy expense, net               | 665                | 651              | 1,397            | 1,350            |
| Furniture and equipment expense      | 453                | 542              | 937              | 1,110            |
| FDIC Assessments                     | 189                | 415              | 514              | 819              |
| Pennsylvania shares tax              | 320                | 306              | 639              | 611              |
| Other operating expense              | 1,680              | 1,607            | 3,376            | 3,611            |
| Total Other Expense                  | \$ 7,794           | \$ 7,703         | \$ 16,057        | \$ 15,700        |

## NON-INTEREST EXPENSE - SIX MONTHS ENDED JUNE 30, 2011 AND 2010

Total noninterest expense in Table VI increased \$357,000 or 2.3% in the six months ended June 30, 2011 from the first six months of 2010. Significant changes include the following:

- Salaries and wages increased \$593,000, or 9.4%. In the first six months of 2011, salaries and wages expense includes officers' incentive stock option compensation of \$244,000; however, since no stock options were awarded in 2010, there was no officers' incentive stock option expense incurred in 2010. In addition, salaries and wages expense in 2011 include an estimated accrual for incentive bonuses of \$600,000 which is \$132,000 higher than the comparable 2010 amount. Excluding performance based stock and bonus compensation incentives, total salaries and wages were 3.1% higher in the first six months of 2011 as compared to the comparable period in 2010.
- Pensions and other employee benefits increased \$402,000, or 20.9%. Within this category, group health insurance expense was \$251,000 higher in 2011. In the first quarter 2010, the Corporation recorded a reduction in group health insurance expense of \$215,000 for the difference between actual and estimated claims from the previous year (2009). Payroll taxes and employer contributions expense associated with the Savings & Retirement Plan (a 401(k) plan) and Employee Stock Ownership Plan are higher in the first six months of 2011 than in the same period of 2010, including higher costs in the first quarter 2011 related to incentive compensation paid in January 2011 based on 2010 performance.
- Furniture and equipment expense decreased \$173,000, or 15.6% in 2011 with the decrease primarily associated with reductions in depreciation for the Corporation's core banking systems.
-

FDIC Assessments decreased \$305,000, or 37.2% in 2011. Effective April 1, 2011, the FDIC's method of determining assessments to banks has changed, with the new methodology expected to result in higher assessments to larger, more complex or higher-risk institutions, with smaller assessments to many community and small regional banks. The Corporation's estimated FDIC assessment for the second quarter 2011, determined using the new methodology, is substantially lower than the amounts assessed for the prior several quarters. The favorable decline also reflects rate changes attributed to improvements in the Corporation's risk profile based on financial ratios.

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• Other operating expense decreased \$235,000, or 6.5%, in the first six months of 2011 as compared to the comparable period in 2010. This category includes many different types of expenses, with the most significant differences in amounts between 2011 and 2010 as follows:

- Ø Professional fees and other costs associated with public company requirements, down \$108,000, or 50.7%
  - Ø Consulting fees associated with an overdraft privilege program, down \$74,000, or 97.0%
    - Ø Office supplies, down \$61,000, or 33.0%
  - Ø Expenses associated with other real estate properties, down \$38,000, or 54.2%
- Ø Professional and administrative expenses associated with Citizens & Northern Investment Corporation activities, down \$37,000, or 88.4%
  - Ø Out-of-pocket collection-related expenses, net of reimbursements, down \$35,000, or 82.2%
  - Ø Operational losses associated with Trust and branch processing, down \$33,000, or 67.1%
  - Ø Amortization of core deposit intangibles from 2005 and 2007 acquisitions, down \$31,000, or 35.0%
- Ø Expenses associated with Bucktail Life Insurance Company, up \$155,000. In the second quarter 2010, the Corporation recorded a reduction in estimated insurance reserves, which reduced Bucktail-related expenses by \$245,000.
  - Ø Fees paid related to interchange and ATM processing increased \$57,000, or 13.1%

NON-INTEREST EXPENSE - THREE MONTHS ENDED JUNE 30, 2011 AND 2010

Total noninterest expense increased \$91,000 or 1.2% in the second quarter 2011 as compared to the second quarter 2010. Significant changes include the following:

- Salaries and wages increased \$270,000, or 8.4%. Officers' incentive stock option compensation totaled \$122,000 in the second quarter 2011, with no corresponding expense incurred in 2010. The second quarter 2011 estimated incentive bonus expense was \$300,000, or \$44,000 higher than the comparable 2010 amount. Excluding performance based stock and bonus compensation incentives, total salaries and wages were 3.0% higher in the second quarter 2011 as compared to the second quarter 2010.
- Furniture and equipment expense decreased \$89,000, or 16.4% in the second quarter 2011 as compared to 2010, with the decrease (as described in the six month analysis above) primarily associated with computer software and hardware-related depreciation and amortization.
- FDIC Assessments decreased \$226,000, or 54.5% in the second quarter 2011 as compared to the second quarter 2010. As described in the six month analysis above, the FDIC's method of determining assessments has changed, resulting in an estimated lower assessment for the second quarter 2011.
- Other operating expense increased \$73,000, or 4.5%, in the second quarter as compared to the second quarter 2010. The most significant differences in individual types of expenses within this category between the second quarters of 2011 and 2010 are as follows:

- Ø Expenses associated with Bucktail Life Insurance Company, up \$215,000. In the second quarter 2010, the Corporation recorded a reduction in estimated insurance reserves, which reduced Bucktail-related expenses by \$245,000.
  - Ø Software-related subscriptions, up \$35,000, or 25.8%
  - Ø Fees paid related to interchange and ATM processing increased \$29,000, or 12.8%
  - Ø Professional fees and other costs associated with public company requirements, down \$58,000, or 53.1%

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- Ø Postage expense, down \$32,000, or 28.8%
- Ø Attorney fees, primarily associated with loan collection activities, down \$31,000, or 46.2%
- Ø Office supplies, down \$25,000, or 30.2%
- Ø Consulting fees associated with an overdraft privilege program, down \$24,000, or 94.6%

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FINANCIAL CONDITION

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

Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition in 2011.

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. Note 6 to the consolidated financial statements provides an overview of the process management uses for evaluating and determining the allowance for loan losses.

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

The allowance for loan losses was \$8,269,000 at June 30, 2011 down from \$9,107,000 at December 31, 2010. As presented in Table VIII, the specific component of the allowance on impaired loans decreased to \$1,582,000 at June 30, 2011 from \$2,288,000 at December 31, 2010. Table VIII also shows that the collectively determined components of the allowance fell by a total of \$249,000 as of June 30, 2011 compared to December 31, 2010, mainly because total outstanding loans decreased for each segment of the portfolio. The average net charge-off percentages and average qualitative factors used in determining the collectively evaluated components of the allowance did not change significantly at June 30, 2011 as compared to the December 31, 2010 analysis.

The decrease in the allowance on impaired loans at June 30, 2011 as compared to December 31, 2010 included the following significant transactions:

- In the second quarter 2011 charge-offs totaling \$663,000 were recorded related to a commercial relationship for which specific allowances totaling \$765,000 had been established at December 31, 2010. After the impact of these charge-offs and re-evaluation of the allowances required, the Corporation had loans outstanding totaling \$925,000 with a specific allowance of \$400,000 at June 30, 2011 related to this commercial borrower.
- In the second quarter 2011, a charge-off of \$46,000 was recorded for a commercial relationship for which specific allowances totaling \$200,000 had been established at December 31, 2010. After the impact of the charge-off, there were no loans outstanding from this borrower, and a balance in foreclosed assets held for sale of \$412,000 at June 30, 2011, based on the estimated fair value of real estate that had collateralized the loans.
- In the first quarter 2011, the Corporation was paid off in full on a commercial loan relationship for which an allowance of \$150,000 had been established at December 31, 2010.



Table VII shows a credit for loan losses of \$161,000 for the first six months of 2011, in comparison to a provision for loan losses of \$283,000 in the first six months of 2010 and the average annual provision over the previous five years of \$796,000. 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 light of all of the factors described above. Note 6 to the consolidated financial statements includes a summary of the provision for loan losses and activity in the allowance for loan losses, by segment and class, for both the year to date and most recent quarter of 2011.

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Table IX presents information related to past due and impaired loans. As of June 30, 2011, total impaired loans were \$6,174,000, down from \$8,648,000 at December 31, 2010, as well as from the comparable annual average level of \$6,898,000 for the last five years. Nonaccrual loans decreased to \$7,586,000 at June 30, 2011 from \$10,809,000 at December 31, 2010, and total loans past due 90 days or more and still in accrual status also decreased to \$561,000 at June 30, 2011 from \$727,000 at December 31, 2010. 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 2006-2010 and the first six months of 2011, each period includes a few large commercial relationships that have required significant monitoring and workout efforts. As a result, a limited number of relationships may significantly impact the total amount of allowance required on impaired loans, and may significantly impact the amount of total charge-offs reported in any one period.

Management believes it has been conservative in its decisions concerning identification of impaired loans, estimates of loss, and nonaccrual status; however, the actual losses realized from these relationships could vary materially from the allowances calculated as of June 30, 2011. 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 VII through X present historical data related to the allowance for loan losses.

TABLE VII - ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

| (In Thousands)                                    | Six Months Ended |                  | Years Ended December 31, |          |          |          |          |
|---|------------------|------------------|--------------------------|----------|----------|----------|----------|
|   | June 30,<br>2011 | June 30,<br>2010 | 2010                     | 2009     | 2008     | 2007     | 2006     |
| Balance, beginning of year                        | \$ 9,107         | \$ 8,265         | \$ 8,265                 | \$ 7,857 | \$ 8,859 | \$ 8,201 | \$ 8,361 |
| Charge-offs:                                      |                  |                  |                          |          |          |          |          |
| Consumer mortgage                                 | (79 )            | (127 )           | (340 )                   | (146 )   | (173 )   | (149 )   | (611 )   |
| Commercial  | (734 )           | (51 )            | (91 )                    | (39 )    | (1,607 ) | (174 )   | (200 )   |
| Consumer  | (84 )            | (92 )            | (188 )                   | (293 )   | (259 )   | (221 )   | (281 )   |
| Total charge-offs                                 | (897 )           | (270 )           | (619 )                   | (478 )   | (2,039 ) | (544 )   | (1,092 ) |
| Recoveries:                                       |                  |                  |                          |          |          |          |          |
| Consumer mortgage                                 | 0                | 21               | 55                       | 8        | 19       | 5        | 11       |
| Commercial  | 177              | 111              | 113                      | 77       | 22       | 31       | 159      |
| Consumer  | 43               | 51               | 102                      | 121      | 87       | 50       | 90       |
| Total recoveries                                  | 220              | 183              | 270                      | 206      | 128      | 86       | 260      |
| Net charge-offs                                   | (677 )           | (87 )            | (349 )                   | (272 )   | (1,911 ) | (458 )   | (832 )   |
| Allowance for loan losses recorded in acquisition | 0                | 0                | 0                        | 0        | 0        | 587      | 0        |
| (Credit) provision for loan losses                | (161 )           | 283              | 1,191                    | 680      | 909      | 529      | 672      |
| Balance, end of year                              | \$ 8,269         | \$ 8,461         | \$ 9,107                 | \$ 8,265 | \$ 7,857 | \$ 8,859 | \$ 8,201 |

TABLE VIII - COMPONENTS OF THE ALLOWANCE FOR LOAN LOSSES

(In Thousands) As of

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|                                   | June 30,<br>2011 | 2010     | 2009     | As of December 31,<br>2008 | 2007     | 2006     |
|-----------------------------------|------------------|----------|----------|----------------------------|----------|----------|
| ASC 310 - Impaired<br>loans       | \$ 1,582         | \$ 2,288 | \$ 1,126 | \$ 456                     | \$ 2,255 | \$ 1,726 |
| ASC 450 - Collective<br>segments: |                  |          |          |                            |          |          |
| Commercial                        | 2,890            | 3,047    | 2,677    | 2,654                      | 1,870    | 2,372    |
| Consumer mortgage                 | 3,150            | 3,227    | 3,859    | 3,920                      | 4,201    | 3,556    |
| Consumer                          | 217              | 232      | 281      | 399                        | 533      | 523      |
| Unallocated                       | 430              | 313      | 322      | 428                        | 0        | 24       |
| Total Allowance                   | \$ 8,269         | \$ 9,107 | \$ 8,265 | \$ 7,857                   | \$ 8,859 | \$ 8,201 |

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TABLE IX - PAST DUE AND IMPAIRED LOANS AND NON-PERFORMING ASSETS

| (In Thousands)  | As of<br>June 30 |          | As of December 31, |         |          |          |
|---|------------------|----------|--------------------|---------|----------|----------|
|   | 2011             | 2010     | 2009               | 2008    | 2007     | 2006     |
| Impaired loans with a valuation allowance               | \$4,049          | \$5,457  | \$2,690            | \$2,230 | \$5,361  | \$5,337  |
| Impaired loans without a valuation allowance            | 2,125            | 3,191    | 3,257              | 3,435   | 857      | 2,674    |
| Total impaired loans                                    | \$6,174          | \$8,648  | \$5,947            | \$5,665 | \$6,218  | \$8,011  |
| Restructured loans (troubled debt restructurings)       | \$4,303          | \$645    | \$326              | \$0     | \$0      | \$111    |
| Total loans past due 30-89 days and still accruing      | \$6,611          | \$7,125  | \$9,445            | \$9,875 | \$10,822 | \$8,580  |
| <b>Nonperforming assets:</b>                            |                  |          |                    |         |          |          |
| Total nonaccrual loans                                  | \$7,586          | \$10,809 | \$9,092            | \$7,200 | \$6,955  | \$8,506  |
| Total loans past due 90 days or more and still accruing | 561              | 727      | 31                 | 1,305   | 1,200    | 1,559    |
| Foreclosed assets held for sale (real estate)           | 1,665            | 537      | 873                | 298     | 258      | 264      |
| Total nonperforming assets                              | \$9,812          | \$12,073 | \$9,996            | \$8,803 | \$8,413  | \$10,329 |
| Total nonperforming assets as a % of assets             | 0.75             | % 0.92   | % 0.76             | % 0.69  | % 0.66   | % 0.78   |

TABLE X - SUMMARY OF LOANS BY TYPE

| Summary of Loans by Type<br>(In Thousands) | June 30,  |           | As of December 31, |           |           |           |
|--|-----------|-----------|--------------------|-----------|-----------|-----------|
|  | 2011      | 2010      | 2009               | 2008      | 2007      | 2006      |
| <b>Consumer mortgage:</b>                  |           |           |                    |           |           |           |
| Residential mortgage loans - first liens   | \$334,300 | \$333,012 | \$340,268          | \$353,909 | \$363,467 | \$325,107 |
| Residential mortgage loans - junior liens  | 30,214    | 31,590    | 35,734             | 40,657    | 40,392    | 30,074    |
| Home equity lines of credit                | 28,544    | 26,853    | 23,577             | 21,304    | 20,542    | 18,472    |
| 1-4 Family residential construction        | 8,574     | 14,379    | 11,452             | 11,262    | 4,742     | 0         |
| Total consumer mortgage                    | 401,632   | 405,834   | 411,031            | 427,132   | 429,143   | 373,653   |
| <b>Commercial:</b>                         |           |           |                    |           |           |           |
| Commercial loans secured by real estate    | 157,282   | 167,094   | 163,483            | 165,979   | 144,742   | 178,260   |
| Commercial and industrial                  | 59,791    | 59,005    | 49,753             | 48,295    | 52,241    | 39,135    |
| Political subdivisions                     | 34,675    | 36,480    | 37,598             | 38,790    | 33,013    | 32,407    |
| Commercial construction                    | 24,726    | 24,004    | 15,264             | 13,730    | 17,755    | 10,365    |
| Loans secured by farmland                  | 10,927    | 11,353    | 11,856             | 9,140     | 8,287     | 6,968     |
|  | 7,514     | 7,781     | 8,338              | 8,367     | 9,004     | 6,790     |

|   |           |           |           |           |           |           |
|---|-----------|-----------|-----------|-----------|-----------|-----------|
| Multi-family (5 or more)<br>residential |           |           |           |           |           |           |
| Agricultural loans                      | 3,182     | 3,472     | 3,848     | 4,495     | 3,553     | 2,705     |
| Other commercial loans                  | 576       | 392       | 638       | 884       | 1,010     | 1,226     |
| Total commercial                        | 298,673   | 309,581   | 290,778   | 289,680   | 269,605   | 277,856   |
| Consumer                                | 13,631    | 14,996    | 19,202    | 26,732    | 37,193    | 35,992    |
| Total                                   | 713,936   | 730,411   | 721,011   | 743,544   | 735,941   | 687,501   |
| Less: allowance for loan losses         | (8,269 )  | (9,107 )  | (8,265 )  | (7,857 )  | (8,859 )  | (8,201 )  |
| Loans, net                              | \$705,667 | \$721,304 | \$712,746 | \$735,687 | \$727,082 | \$679,300 |

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## LIQUIDITY

Liquidity is the ability to quickly raise cash at a reasonable cost. An adequate liquidity position permits the Corporation to pay creditors, compensate for unforeseen deposit fluctuations and fund unexpected loan demand. At June 30, 2011, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$34,205,000.

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 \$27,555,000 at June 30, 2011.

The Corporation's outstanding, available, and total credit facilities are presented in the following table.

| (In Thousands)                       | Outstanding      |                  | Available        |                  | Total Credit     |                  |
|--------------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
|                                      | June 30,<br>2011 | Dec. 31,<br>2010 | June 30,<br>2011 | Dec. 31,<br>2010 | June 30,<br>2011 | Dec. 31,<br>2010 |
| Federal Home Loan Bank of Pittsburgh | \$40,682         | \$55,995         | \$289,800        | \$304,584        | \$330,482        | \$360,579        |
| Federal Reserve Bank Discount Window | 0                | 0                | 26,334           | 26,274           | 26,334           | 26,274           |
| Other correspondent banks            | 0                | 0                | 25,000           | 25,000           | 25,000           | 25,000           |
| Total credit facilities              | \$40,682         | \$55,995         | \$341,134        | \$355,858        | \$381,816        | \$411,853        |

At June 30, 2011 and December 31, 2010, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of long-term borrowings. No letters of credit were outstanding at either date.

Additionally, the Corporation uses repurchase agreements placed with brokers to borrow funds secured by investment assets, and uses "RepoSweep" arrangements to borrow funds from commercial banking customers on an overnight basis. If required to raise cash in an emergency situation, the Corporation could sell non-pledged investment securities to meet its obligations. At June 30, 2011, the carrying value of non-pledged available-for-sale securities was \$55,839,000.

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

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## STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY

The Corporation and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning capital ratios at June 30, 2011 and December 31, 2010 are presented below. Management believes, as of June 30, 2011 and December 31, 2010, that the Corporation and C&N Bank meet all capital adequacy requirements to which they are subject.

|   | Actual     |         | Minimum Capital Requirement |                 | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |                  |
|---|------------|---------|-----------------------------|-----------------|--|------------------|
|   | Amount     | Ratio   | Amount                      | Ratio           | Amount   | Ratio            |
| (Dollars in Thousands)                  |            |         |                             |                 |  |                  |
| June 30, 2011:                          |            |         |                             |                 |  |                  |
| Total capital to risk-weighted assets:  |            |         |                             |                 |  |                  |
| Consolidated                            | \$ 140,538 | 19.40 % | \$ 57,961                   | <sup>38</sup> % | n/a  | n/a              |
| C&N Bank                                | 129,564    | 18.06 % | 57,408                      | <sup>38</sup> % | \$ 71,760  | <sup>310</sup> % |
| Tier 1 capital to risk-weighted assets: |            |         |                             |                 |  |                  |
| Consolidated                            | 131,492    | 18.15 % | 28,981                      | <sup>34</sup> % | n/a  | n/a              |
| C&N Bank                                | 121,259    | 16.90 % | 28,704                      | <sup>34</sup> % | 43,056   | <sup>36</sup> %  |
| Tier 1 capital to average assets:       |            |         |                             |                 |  |                  |
| Consolidated                            | 131,492    | 10.14 % | 51,849                      | <sup>34</sup> % | n/a  | n/a              |
| C&N Bank                                | 121,259    | 9.43 %  | 51,435                      | <sup>34</sup> % | 64,294   | <sup>35</sup> %  |
| December 31, 2010:                      |            |         |                             |                 |  |                  |
| Total capital to risk-weighted assets:  |            |         |                             |                 |  |                  |
| Consolidated                            | \$ 128,527 | 17.17 % | \$ 59,874                   | <sup>38</sup> % | n/a  | n/a              |
| C&N Bank                                | 117,576    | 15.85 % | 59,342                      | <sup>38</sup> % | \$ 74,177  | <sup>310</sup> % |
| Tier 1 capital to risk-weighted assets: |            |         |                             |                 |  |                  |
| Consolidated                            | 118,781    | 15.87 % | 29,937                      | <sup>34</sup> % | n/a  | n/a              |
| C&N Bank                                | 108,445    | 14.62 % | 29,671                      | <sup>34</sup> % | 44,506   | <sup>36</sup> %  |
| Tier 1 capital to average assets:       |            |         |                             |                 |  |                  |
| Consolidated                            | 118,781    | 9.20 %  | 51,664                      | <sup>34</sup> % | n/a  | n/a              |
| C&N Bank                                | 108,445    | 8.50 %  | 51,063                      | <sup>34</sup> % | 63,828   | <sup>35</sup> %  |

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

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

The Corporation's total stockholders' equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in "Accumulated Other Comprehensive Income (Loss)" within stockholders' equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains or losses on available-for-sale securities, net of deferred income tax, amounted to \$5,299,000 at June 30, 2011 and (\$1,351,000) at December 31, 2010. Changes in accumulated other comprehensive income are excluded from earnings and directly increase or decrease stockholders' equity. If available-for-sale securities are deemed to be other-than-temporarily impaired, unrealized losses are recorded as a charge against earnings, and amortized cost for the affected securities is reduced. Note 5 to the consolidated financial statements provides additional information concerning management's evaluation of available-for-sale securities for other-than-temporary impairment at June 30, 2011.



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Stockholders' equity is also affected by the underfunded or overfunded status of defined benefit pension and postretirement plans. The balance in Accumulated Other Comprehensive Income (Loss) related to underfunded defined benefit plans, net of deferred income tax, was (\$313,000) at June 30, 2011 and (\$250,000) at December 31, 2010.

## INCOME TAXES

The effective income tax rate was 27.17% of pre-tax income for the six months ended June 30, 2011 compared to 22.60% of pre-tax income for the first six months of 2010. The provision for income tax for the six-month periods ended June 30, 2011 and 2010 is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income. The provision for income tax in the second quarter 2010 included a benefit (reduction in expense) of \$225,000 resulting from a reduction in a valuation reserve.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At June 30, 2011, the net deferred tax asset was \$10,099,000, down from the balance at December 31, 2010 of \$16,054,000. Some of the significant components of the net reduction in deferred tax asset at June 30, 2011 as compared to December 31, 2010 are as follows:

- At June 30, 2011, the Corporation had a deferred tax liability of \$2,730,000 associated with net unrealized gains on available-for-sale securities. In comparison, at December 31, 2010, there was a deferred tax asset of \$695,000 associated with net unrealized losses on available-for-sale securities. Changes in unrealized gains and losses on available-for-sale securities, net of deferred income tax, are excluded from the determination of earnings but are included in Comprehensive Income.
- The net deferred tax asset balance at June 30, 2011 attributable to realized securities losses was \$3,416,000, significantly lower than the balance at December 31, 2010 of \$5,755,000. As described in Note 5 to the consolidated financial statements, in the first quarter 2011, the Corporation sold a pooled trust-preferred security that had been written off in 2009 and 2010 for financial statement purposes, resulting in a book gain of \$1,485,000. The loss for income tax purposes from this transaction is \$5,295,000, with the large book/ tax difference representing the main reason for the reduction in the deferred tax asset.
- The Corporation has available an estimated \$2,612,000 of total unused operating loss carryforwards at June 30, 2011, including a capital loss carryforward of \$369,000 expiring in 2015, and an estimated ordinary loss carryforward of \$2,243,000 almost all of which expires in 2030. The amount of deferred tax asset from unused loss carryforwards at June 30, 2011 of \$888,000 is down from \$2,794,000 at December 31, 2010, primarily as a result of estimated taxable income generated in the first six months of 2011.
- At June 30, 2011, the deferred tax asset based on the credit for alternative minimum tax (AMT) paid was \$4,814,000, up from \$3,287,000 at December 31, 2010. The increase in 2011 reflects estimated AMT payable for the first six months of 2011. Although the Corporation has an unused operating loss carryforward for purposes of determining regular federal taxable income, the cumulative effect of items treated differently for AMT purposes (including, most significantly, tax exempt interest income) has eliminated any AMT loss carryforward from 2010 and is expected to trigger payment of AMT for 2011. Realization of the deferred tax asset for AMT depends on generation of sufficient ordinary taxable income in excess of AMT income in future years, though there is no expiration of the credit for AMT paid under current tax law.

The Corporation regularly reviews deferred tax assets for recoverability based on history of earnings, expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. Management believes the recorded net deferred tax asset at June 30, 2011 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.

In the fourth quarter 2009, the Corporation sold some securities for which other-than-temporary impairment losses (OTTI) had been recognized for financial reporting purposes in 2008 and the first nine months of 2009. As a result of these sales, the Corporation realized both ordinary and capital tax losses for 2009, and filed net operating loss carryback returns resulting in tax refunds totaling \$4,352,000 received in 2010 from recovery of some of the taxes previously paid for 2006, 2007 and 2008. In late 2010, the Internal Revenue Service (IRS) sent the Corporation an information document request related to the Corporation's 2009 federal return, as part of an evaluation to determine whether the return will be examined or accepted without examination. The Corporation has responded to the information document request, and has not yet received a final determination from the IRS.

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Additional information related to income taxes is presented in Note 9 to the consolidated financial statements.

INFLATION

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in short-term interest rates. Beginning in September 2007, in response to concerns about weakness in the U.S. economy, the Federal Reserve lowered the fed funds target rate numerous times; in December 2008, it took the unusual step of establishing a target range of 0% to 0.25%, which it has maintained through 2010 and the first six months of 2011. Also, the Federal Reserve has injected massive amounts of liquidity into the nation's monetary system through a variety of programs. The Federal Reserve has purchased large amounts of securities in an effort to keep interest rates low and stimulate economic growth. Recent commodity price increases have sparked concern that inflation may become a concern in the near future, but Federal Reserve officials have publicly stated that the current inflation level is within an acceptable range.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

MARKET RISK

Market risk is the risk of loss arising from adverse changes in market rates and prices of the Corporation's financial instruments. In addition to the effects of interest rates, the market prices of the Corporation's debt securities within the available-for-sale securities portfolio are affected by fluctuations in the risk premiums (amounts of spread over risk-free rates) demanded by investors.

Management cannot control changes in market prices of securities based on fluctuations in the risk premiums demanded by investors, nor can management control the volume of deferrals or defaults by other entities on trust-preferred securities. However, 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 50-300 basis points of current rates.

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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 provides limits at +/- 100, 200 and 300 basis points from current rates for fluctuations in net interest income from the baseline (flat rates) one-year scenario. The policy also limits acceptable market value variances from the baseline values based on current rates.

Table XI, which follows this discussion, is based on the results of the simulation model as of May 31, 2011 and October 31, 2010. As indicated in the table, the Corporation is liability sensitive, and therefore net interest income and market value generally increase when interest rates fall and decrease when interest rates rise. The table shows that as of May 31, 2011, the changes in net interest income and changes in market value were within the policy limits in all scenarios. As of October 31, 2010, the changes in net interest income and changes in market value were within the policy limits in all scenarios except an immediate rate decrease of 300 basis points, which management considers to be highly unrealistic.

After preparation of the October 31, 2010 modeling results presented in Table XI, management engaged an outside consultant to study the Corporation's non-maturity deposits: checking, savings, and money market accounts. The consultant examined historical data provided by management to estimate the average life of each type of deposit account and the sensitivity of each type of account to changes in interest rates. The results of the study indicated that the Corporation's non-maturity deposits had significantly longer average lives than previously estimated. These updated estimates are included in the May 31, 2011 data presented and result in higher market values in all of the rate scenarios and in smaller percentage declines in value in rising rate scenarios. The study also indicated that the Corporation's interest rates on non-maturity deposits were slightly more sensitive to market changes than had previously been assumed, which contributed to the larger declines in net interest income in rising rate scenarios based on May 31, 2011 data.

In December 2007, the Corporation entered into repurchase agreements (borrowings) totaling \$80 million to fund the purchase of investment securities. The borrowings include embedded caps providing that, if 3-month LIBOR were to exceed 5.15%, the interest rate payable on the repurchase agreements would fall, down to a minimum of 0%, based on parameters included in the repurchase agreements. Three-month LIBOR has not exceeded 5.15% since the embedded caps were acquired; therefore, they have not affected interest expense to date. The embedded cap on one of the \$40 million borrowings expired in December 2010, and the embedded cap on the other \$40 million borrowing expires in December 2012. The 3-month LIBOR was 0.25% at May 31, 2011 and 0.29% at October 31, 2010. Since the embedded caps are effective only when 3-month LIBOR exceeds 5.15%, the Corporation would be unable to realize an interest expense reduction in any of the scenarios shown in Table XI at May 2011 or October 2010.

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.

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TABLE XI - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES

May 31, 2011 Data

(In Thousands)

Period Ending May 31, 2012

| Basis Point Change in Rates | Interest  | Interest  | Net Interest | NII      | NII        |   |   |
|-----------------------------|-----------|-----------|--------------|----------|------------|---|---|
|                             | Income    | Expense   | Income (NII) | % Change | Risk Limit |   |   |
| +300                        | \$ 65,083 | \$ 26,978 | \$ 38,105    | -14.9 %  | 20.0       | % | % |
| +200                        | 62,527    | 22,166    | 40,361       | -9.8 %   | 15.0       | % | % |
| +100                        | 59,945    | 17,354    | 42,591       | -4.8 %   | 10.0       | % | % |
| 0                           | 57,299    | 12,541    | 44,758       | 0.0 %    | 0.0        | % | % |
| -100                        | 53,826    | 10,612    | 43,214       | -3.4 %   | 10.0       | % | % |
| -200                        | 51,763    | 10,200    | 41,563       | -7.1 %   | 15.0       | % | % |
| -300                        | 51,205    | 10,197    | 41,008       | -8.4 %   | 20.0       | % | % |

## Market Value of Portfolio Equity

At May 31, 2011

| Basis Point Change in Rates | Present    | Present  | Present    |          |            |
|-----------------------------|------------|----------|------------|----------|------------|
|                             | Value      | Value    | Value      | % Change | Risk Limit |
|                             | Equity     | % Change | Risk Limit |          |            |
| +300                        | \$ 146,234 | -21.7 %  | 45.0       | %        | %          |
| +200                        | 161,090    | -13.7 %  | 35.0       | %        | %          |
| +100                        | 173,999    | -6.8 %   | 25.0       | %        | %          |
| 0                           | 186,742    | 0.0 %    | 0.0        | %        | %          |
| -100                        | 185,656    | -0.6 %   | 25.0       | %        | %          |
| -200                        | 193,079    | 3.4 %    | 35.0       | %        | %          |
| -300                        | 212,783    | 13.9 %   | 45.0       | %        | %          |

October 31, 2010 Data

(In Thousands)

Period Ending October 31, 2011

| Basis Point Change in Rates | Interest  | Interest  | Net Interest | NII      | NII        |   |   |
|-----------------------------|-----------|-----------|--------------|----------|------------|---|---|
|                             | Income    | Expense   | Income (NII) | % Change | Risk Limit |   |   |
| +300                        | \$ 66,098 | \$ 27,402 | \$ 38,696    | -9.3 %   | 20.0       | % | % |
| +200                        | 63,465    | 23,146    | 40,319       | -5.5 %   | 15.0       | % | % |
| +100                        | 60,661    | 18,891    | 41,770       | -2.1 %   | 10.0       | % | % |
| 0                           | 57,307    | 14,638    | 42,669       | 0.0 %    | 0.0        | % | % |
| -100                        | 54,005    | 13,794    | 40,211       | -5.8 %   | 10.0       | % | % |
| -200                        | 51,995    | 13,732    | 38,263       | -10.3 %  | 15.0       | % | % |
| -300                        | 51,507    | 13,732    | 37,775       | -11.5 %  | 20.0       | % | % |

## Market Value of Portfolio Equity

at October 31, 2010

| Basis Point Change in Rates | Present Value Equity | Present Value % Change | Present Value Risk Limit |
|-----------------------------|----------------------|------------------------|--------------------------|
| +300                        | \$ 90,782            | -28.4 %                | 45.0 %                   |
| +200                        | 104,337              | -17.7 %                | 35.0 %                   |
| +100                        | 116,495              | -8.1 %                 | 25.0 %                   |
| 0                           | 126,789              | 0.0 %                  | 0.0 %                    |
| -100                        | 135,342              | 6.7 %                  | 25.0 %                   |
| -200                        | 162,919              | 28.5 %                 | 35.0 %                   |
| -300                        | 194,064              | 53.1 %                 | 45.0 %                   |

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## EQUITY SECURITIES RISK

The Corporation's equity securities portfolio consists of investments in stock 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 5 of the consolidated financial statements, the Corporation recognized no OTTI charges on bank stocks in the first six months of 2011. The Corporation recognized no OTTI charges on bank stocks during the second quarter 2010 but recognized OTTI charges on bank stocks totaling \$10,000 in the first six months of 2010.

Equity securities held as of June 30, 2011 and December 31, 2010 are presented in Table XII. Table XII 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 XII 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 June 30, 2011.

TABLE XII - EQUITY SECURITIES RISK  
(In Thousands)

|  | June 30,<br>2011 | Dec. 31,<br>2010 |
|--|------------------|------------------|
| Cost                                     | \$ 4,883         | \$ 4,589         |
| Fair Value                               | 6,611            | 6,009            |
| Hypothetical 10% Decline In Market Value | (661 )           | (601 )           |
| Hypothetical 20% Decline In Market Value | (1,322 )         | (1,202 )         |

## ITEM 4. CONTROLS AND PROCEDURES

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

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



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PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation's Form 10-K filed March 1, 2011.

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

Issuer Purchases of Equity Securities

On May 19, 2011, the Corporation announced the Corporation's Board of Directors authorized repurchases of outstanding common stock, up to a total of \$1 million, in open market or privately negotiated transactions. The Board of Directors' authorization provides that: (1) this 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 this 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. As of June 30, 2011, the maximum additional value available for purchases under this program was \$428,548.

The following table sets forth a summary of the purchases by the Corporation, on the open market, of its equity securities in the second quarter 2011:

| Period            | Total Number<br>of Shares<br>Purchased | Average Price<br>Paid per Share | Total Number of<br>Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs |            | Maximum Dollar<br>Value of Shares<br>that May Yet be<br>Purchased<br>Under the Plans<br>or Programs |
|-------------------|--|---------------------------------|--|------------|---|
|                   |  |                                 |  |            |   |
| May 1 - 31, 2011  | 16,000                                 | \$ 14.48                        | 16,000   | \$ 768,320 |   |
| June 1 - 30, 2011 | 24,302                                 | \$ 13.98                        | 40,302   | \$ 428,548 |   |

Item 3. Defaults Upon Senior Securities

None

Item 4. Removed and Reserved

Item 5. Other Information

None



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Item 6. Exhibits

|  |   |
|--|---|
| 2. Plan of acquisition, reorganization, arrangement, liquidation or succession | Not applicable  |
| 3. (i) Articles of Incorporation   | Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed September 21, 2009   |
| 3. (ii) By-laws  | Incorporated by reference to Exhibit 3.2 of the Corporation's Form 8-K filed September 21, 2009   |
| 4. Instruments defining the rights of security holders, including indentures   | Not applicable  |
| 11. Statement re: computation of per share earnings                            | Information concerning the computation of earnings per share is provided in Note 2 to the Consolidated Financial Statements, which is included in Part I, Item 1 of Form 10-Q |
| 15. Letter re: unaudited interim financial information                         | Not applicable  |
| 18. Letter re: change in accounting principles                                 | Not applicable  |
| 19. Report furnished to security holders                                       | Not applicable  |
| 22. Published report regarding matters submitted to vote of security holders   | Not applicable  |
| 23. Consents of experts and counsel  | Not applicable  |
| 24. Power of attorney  | Not applicable  |
| 31. Rule 13a-14(a)/15d-14(a) certifications:                                   |   |
| 31.1 Certification of Chief Executive Officer                                  | Filed herewith  |
| 31.2 Certification of Chief Financial Officer                                  | Filed herewith  |
| 32. Section 1350 certifications  | Provided herewith   |
| 99. Additional exhibits  | Not applicable  |
| 100. XBRL-related documents  | Not applicable  |
| 101. Interactive Data File   | Furnished herewith*   |

\* These interactive data files shall not be deemed filed for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under

those sections.

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Signatures  
SIGNATURES

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

CITIZENS & NORTHERN CORPORATION

August 8, 2011  
Date

By: /s/ Charles H. Updegraff, Jr.  
President and Chief Executive Officer

August 8, 2011  
Date

By: /s/ Mark A. Hughes  
Treasurer and Chief Financial Officer