

CITIZENS & NORTHERN CORP  
Form 10-Q  
May 08, 2012

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 March 31, 2012

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

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(Address of principal executive offices) (Zip code)

570-724-3411

(Registrant's telephone number including area code)

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

Yes  No

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

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

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

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

Yes  No

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

Common Stock (\$1.00 par value) 12,216,950 Shares Outstanding on May 4, 2012

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

**CITIZENS & NORTHERN CORPORATION**

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**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****PART 1. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CONSOLIDATED BALANCE SHEETS (Unaudited)**

| (In Thousands Except Share Data)   | March 31,<br>2012   | December 31,<br>2011 |
|--|---------------------|----------------------|
| <b>ASSETS</b>  |                     |                      |
| Cash and due from banks:   |                     |                      |
| Noninterest-bearing  | \$ 19,022           | \$ 17,618            |
| Interest-bearing   | 37,476              | 42,957               |
| Total cash and due from banks  | 56,498              | 60,575               |
| Available-for-sale securities, at fair value   | 486,664             | 481,685              |
| Loans held for sale  | 2,223               | 939                  |
| Loans receivable   | 697,588             | 708,315              |
| Allowance for loan losses  | (7,370 )            | (7,705 )             |
| Loans, net   | 690,218             | 700,610              |
| Bank-owned life insurance  | 21,008              | 20,889               |
| Accrued interest receivable  | 4,943               | 4,797                |
| Bank premises and equipment, net   | 18,761              | 19,028               |
| Foreclosed assets held for sale  | 977                 | 1,235                |
| Deferred tax asset, net  | 5,003               | 6,173                |
| Intangible asset - Core deposit intangibles  | 193                 | 212                  |
| Intangible asset - Goodwill  | 11,942              | 11,942               |
| Other assets   | 18,334              | 15,650               |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,316,764</b> | <b>\$ 1,323,735</b>  |
| <b>LIABILITIES</b>   |                     |                      |
| Deposits:  |                     |                      |
| Noninterest-bearing  | \$ 202,439          | \$ 193,595           |
| Interest-bearing   | 814,362             | 824,611              |
| Total deposits   | 1,016,801           | 1,018,206            |
| Short-term borrowings  | 4,030               | 4,950                |
| Long-term borrowings   | 115,202             | 125,363              |
| Accrued interest and other liabilities   | 9,117               | 7,831                |
| <b>TOTAL LIABILITIES</b>   | <b>1,145,150</b>    | <b>1,156,350</b>     |
| <b>STOCKHOLDERS' EQUITY</b>  |                     |                      |
| Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; no shares issued at March 31, 2012 and December 31, 2011 | 0                   | 0                    |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2012 and 2011; issued 12,473,495 at March 31, 2012 and 12,460,920 at December 31, 2011 | 12,474              | 12,461               |

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|   |             |              |
|---|-------------|--------------|
| Paid-in capital   | 67,360      | 67,568       |
| Retained earnings   | 85,715      | 82,302       |
| Treasury stock, at cost; 257,745 shares at March 31, 2012 and 305,391 shares at December 31, 2011 | (4,309 )    | (5,106 )     |
| Sub-total   | 161,240     | 157,225      |
| Accumulated other comprehensive income:   |             |              |
| Unrealized gains on available-for-sale securities   | 10,852      | 10,791       |
| Defined benefit plans   | (478 )      | (631 )       |
| Total accumulated other comprehensive income  | 10,374      | 10,160       |
| TOTAL STOCKHOLDERS' EQUITY  | 171,614     | 167,385      |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY  | \$1,316,764 | \$ 1,323,735 |

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

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

| CONSOLIDATED STATEMENTS OF OPERATIONS   | 3 Months Ended |                |
|---|----------------|----------------|
| (In Thousands, Except Per Share Data) (Unaudited)                             | March 31, 2012 | March 31, 2011 |
| <b>INTEREST INCOME</b>  |                |                |
| Interest and fees on loans  | \$10,375       | \$ 10,868      |
| Interest on balances with depository institutions                             | 28             | 16             |
| Interest on loans to political subdivisions                                   | 377            | 375            |
| Income from available-for-sale and held-to-maturity securities:               |                |                |
| Taxable   | 2,658          | 2,693          |
| Tax-exempt  | 1,263          | 1,284          |
| Dividends   | 75             | 62             |
| Total interest and dividend income  | 14,776         | 15,298         |
| <b>INTEREST EXPENSE</b>   |                |                |
| Interest on deposits  | 1,350          | 2,568          |
| Interest on short-term borrowings   | 3              | 6              |
| Interest on long-term borrowings  | 1,149          | 1,442          |
| Total interest expense  | 2,502          | 4,016          |
| Net interest income   | 12,274         | 11,282         |
| (Credit) provision for loan losses  | (182 )         | (192 )         |
| Net interest income after (credit) provision for loan losses                  | 12,456         | 11,474         |
| <b>OTHER INCOME</b>   |                |                |
| Service charges on deposit accounts   | 1,161          | 1,131          |
| Service charges and fees  | 220            | 218            |
| Trust and financial management revenue  | 929            | 877            |
| Interchange revenue from debit card transactions                              | 495            | 452            |
| Net gains from sale of loans  | 265            | 259            |
| Increase in cash surrender value of life insurance                            | 119            | 122            |
| Insurance commissions, fees and premiums                                      | 34             | 68             |
| Impairment loss on limited partnership investment                             | 0              | (948 )         |
| Other operating income  | 536            | 376            |
| Sub-total   | 3,759          | 2,555          |
| Total other-than-temporary impairment losses on available-for-sale securities | (67 )          | 0              |
| Portion of (gain) recognized in other comprehensive income (before taxes)     | 0              | 0              |
| Net impairment losses recognized in earnings                                  | (67 )          | 0              |
| Realized gains on available-for-sale securities, net                          | 65             | 1,839          |
| Net realized (losses) gains on available-for-sale securities                  | (2 )           | 1,839          |
| Total other income  | 3,757          | 4,394          |
| <b>OTHER EXPENSES</b>   |                |                |
| Salaries and wages  | 3,575          | 3,401          |
| Pensions and other employee benefits  | 1,366          | 1,306          |
| Occupancy expense, net  | 636            | 732            |
| Furniture and equipment expense   | 482            | 484            |
| FDIC Assessments  | 146            | 325            |
| Pennsylvania shares tax   | 332            | 319            |

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|                                    |         |          |
|------------------------------------|---------|----------|
| Other operating expense            | 1,980   | 1,696    |
| Total other expenses               | 8,517   | 8,263    |
| Income before income tax provision | 7,696   | 7,605    |
| Income tax provision               | 2,109   | 2,064    |
| NET INCOME                         | \$5,587 | \$ 5,541 |
| NET INCOME PER SHARE - BASIC       | \$0.46  | \$ 0.46  |
| NET INCOME PER SHARE - DILUTED     | \$0.46  | \$ 0.45  |

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

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

|  | Three Months Ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2012                            | 2011     |
| Net income   | \$ 5,587                        | \$ 5,541 |
| Unrealized gains on available-for-sale securities:   |                                 |          |
| Unrealized holding gains on available-for-sale securities  | 344                             | 6,125    |
| Reclassification adjustment for losses (gains) realized in income  | 2                               | (1,839 ) |
| Other comprehensive gain on available-for-sale securities  | 346                             | 4,286    |
| Unfunded pension and postretirement obligations:   |                                 |          |
| Change in items from defined benefit plans included in accumulated other comprehensive income                              | 200                             | (119 )   |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 20                              | 13       |
| Other comprehensive gain (loss) on unfunded retirement obligations   | 220                             | (106 )   |
| Other comprehensive income before income tax   | 566                             | 4,180    |
| Income tax related to other comprehensive income   | (352 )                          | (1,421 ) |
| Net other comprehensive income   | 214                             | 2,759    |
| Total comprehensive income   | \$ 5,801                        | \$ 8,300 |

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



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

| CONSOLIDATED STATEMENTS OF CASH FLOWS<br>(In Thousands) (Unaudited)               | 3 Months Ended March 31, |               |
|---|--------------------------|---------------|
|   | 2012                     | 2011          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                          |               |
| Net income  | \$ 5,587                 | \$ 5,541      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |               |
| Credit for loan losses  | (182 )                   | (192 )        |
| Realized losses (gains) on available-for-sale securities, net                     | 2                        | (1,839 )      |
| (Gain) loss on sale of foreclosed assets, net                                     | (104 )                   | 19            |
| Depreciation expense  | 493                      | 536           |
| Accretion and amortization on securities, net                                     | 182                      | 446           |
| Accretion and amortization on loans, deposits and borrowings, net                 | (12 )                    | (8 )          |
| Amortization of mortgage servicing rights   | 21                       | 13            |
| Impairment loss on limited partnership interest                                   | 0                        | 948           |
| Increase in cash surrender value of life insurance                                | (119 )                   | (122 )        |
| Stock-based compensation  | 241                      | 192           |
| Amortization of core deposit intangibles  | 19                       | 29            |
| Deferred income taxes   | 818                      | 1,826         |
| Gains on sales of mortgage loans, net   | (265 )                   | (259 )        |
| Origination of mortgage loans for sale  | (9,174 )                 | (4,529 )      |
| Proceeds from sales of mortgage loans   | 8,100                    | 9,798         |
| (Increase) decrease in accrued interest receivable and other assets               | (2,941 )                 | 1,396         |
| Increase (decrease) in accrued interest payable and other liabilities             | 741                      | (844 )        |
| Net Cash Provided by Operating Activities   | 3,407                    | 12,951        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                          |               |
| Purchase of certificates of deposit   | (480 )                   | 0             |
| Proceeds from sales of available-for-sale securities                              | 27                       | 15,950        |
| Proceeds from calls and maturities of available-for-sale securities               | 27,279                   | 26,781        |
| Purchase of available-for-sale securities   | (31,358 )                | (46,069 )     |
| Redemption of Federal Home Loan Bank of Pittsburgh stock                          | 332                      | 408           |
| Net decrease in loans   | 10,094                   | 11,207        |
| Purchase of premises and equipment  | (226 )                   | (86 )         |
| Purchase of investment in limited liability entity                                | (214 )                   | 0             |
| Return of principal on limited liability entity investments                       | 27                       | 70            |
| Proceeds from sale of foreclosed assets   | 858                      | 0             |
| Net Cash Provided by Investing Activities   | 6,339                    | 8,261         |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                          |               |
| Net (decrease) increase in deposits   | (1,409 )                 | 5,648         |
| Net decrease in short-term borrowings   | (920 )                   | (2,345 )      |
| Repayments of long-term borrowings  | (10,161 )                | (10,155 )     |
| Sale of treasury stock  | 101                      | 3             |
| Tax benefit from compensation plans   | 22                       | 15            |
| Common dividends paid   | (1,936 )                 | (1,401 )      |
| Net Cash Used in Financing Activities   | (14,303 )                | (8,235 )      |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>                           | <b>(4,557 )</b>          | <b>12,977</b> |

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|  |           |           |
|--|-----------|-----------|
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 56,815    | 46,301    |
| CASH AND CASH EQUIVALENTS, END OF PERIOD     | \$ 52,258 | \$ 59,278 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

|  |          |          |
|--|----------|----------|
| Assets acquired through foreclosure of real estate loans | \$ 496   | \$ 189   |
| Accrued purchase of available-for-sale securities        | \$ 765   | \$ 0     |
| Interest paid  | \$ 2,573 | \$ 4,049 |
| Income taxes paid  | \$ 300   | \$ 4     |

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

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

## Consolidated Statements of Changes in Stockholders' Equity

## Three Months Ended March 31, 2012 and 2011

(In Thousands Except Share and Per Share Data)

(Unaudited)

|  | Common<br>Shares | Treasury<br>Shares | Common<br>Stock | Paid-in<br>Capital | Retained<br>Earnings | Accum. Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock | Total      |
|--|------------------|--------------------|-----------------|--------------------|----------------------|--|-------------------|------------|
| Three Months Ended March 31, 2012:                               |                  |                    |                 |                    |                      |  |                   |            |
| Balance, December 31, 2011                                       | 12,460,920       | 305,391            | \$ 12,461       | \$ 67,568          | \$ 82,302            | \$ 10,160                                      | \$(5,106)         | \$ 167,385 |
| Net income   |                  |                    |                 |                    | 5,587                |  |                   | 5,587      |
| Other comprehensive income, net                                  |                  |                    |                 |                    |                      | 214  |                   | 214        |
| Cash dividends declared on common stock, \$.18 per share         |                  |                    |                 |                    | (2,196)              |  |                   | (2,196)    |
| Shares issued for dividend reinvestment plan                     | 12,575           |                    | 13              | 247                |                      |  |                   | 260        |
| Shares issued from treasury related to exercise of stock options |                  | (6,835)            |                 | (15)               |                      |  | 116               | 101        |
| Restricted stock granted   |                  | (42,552)           |                 | (711)              |                      |  | 711               | 0          |
| Forfeiture of restricted stock                                   |                  | 1,741              |                 | 30                 |                      |  | (30)              | 0          |
| Stock-based compensation expense                                 |                  |                    |                 | 241                |                      |  |                   | 241        |
| Tax benefit from employee benefit plan                           |                  |                    |                 |                    | 22                   |  |                   | 22         |
| Balance, March 31, 2012  | 12,473,495       | 257,745            | \$ 12,474       | \$ 67,360          | \$ 85,715            | \$ 10,374                                      | \$(4,309)         | \$ 171,614 |
| Three Months Ended March 31, 2011:                               |                  |                    |                 |                    |                      |  |                   |            |
| Balance, December 31, 2010                                       | 12,408,212       | 254,614            | \$ 12,408       | \$ 66,648          | \$ 65,920            | \$(1,601)                                      | \$(4,431)         | \$ 138,944 |
| Net income   |                  |                    |                 |                    | 5,541                |  |                   | 5,541      |
| Other comprehensive income, net                                  |                  |                    |                 |                    |                      | 2,759  |                   | 2,759      |
| Cash dividends declared on common stock, \$.13 per share         |                  |                    |                 |                    | (1,582)              |  |                   | (1,582)    |
| Shares issued for dividend reinvestment plan                     | 12,153           |                    | 12              | 169                |                      |  |                   | 181        |
| Shares issued from treasury related to exercise of stock options |                  | (228)              |                 | (1)                |                      |  | 4                 | 3          |
| Restricted stock granted   |                  | (15,622)           |                 | (272)              |                      |  | 272               | 0          |
| Forfeiture of restricted stock                                   |                  | 189                |                 | 3                  |                      |  | (3)               | 0          |
| Stock-based compensation expense                                 |                  |                    |                 | 192                |                      |  |                   | 192        |
|  |                  |                    |                 |                    | 15                   |  |                   | 15         |

Tax benefit from employee benefit  
plan

|                         |            |         |          |          |          |          |           |           |
|-------------------------|------------|---------|----------|----------|----------|----------|-----------|-----------|
| Balance, March 31, 2011 | 12,420,365 | 238,953 | \$12,420 | \$66,739 | \$69,894 | \$ 1,158 | \$(4,158) | \$146,053 |
|-------------------------|------------|---------|----------|----------|----------|----------|-----------|-----------|

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****Notes to Unaudited Consolidated Financial Statements****1. BASIS OF INTERIM PRESENTATION**

The consolidated financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2011, is unaudited. Such information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations, comprehensive income, cash flows and changes in stockholders' equity for the interim periods; however, the information does not include all disclosures required by accounting principles generally accepted in the United States of America ("U.S. GAAP") for a complete set of financial statements. Certain 2011 information has been reclassified for consistency with the 2012 presentation.

Operating results reported for the three-month period ended March 31, 2012 might not be indicative of the results for the year ending December 31, 2012. 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 |
|---|--|--|--------------------------|
| Quarter Ended March 31, 2012  |  |  |                          |
| Earnings per common share – basic                                     | \$ 5,587,000   | 12,206,870                               | \$ 0.46                  |
| Dilutive effect of potential common stock arising from stock options: |  |  |                          |
| Exercise of outstanding stock options                                 |  | 271,980                                  |                          |
| Hypothetical share repurchase at \$15.57                              |  | (233,098 )                               |                          |

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|   |              |            |         |
|---|--------------|------------|---------|
| Earnings per common share – diluted<br>Quarter Ended March 31, 2011   | \$ 5,587,000 | 12,245,752 | \$ 0.46 |
| Earnings per common share – basic                                     | \$ 5,541,000 | 12,174,935 | \$ 0.46 |
| Dilutive effect of potential common stock arising from stock options: |              |            |         |
| Exercise of outstanding stock options                                 |              | 255,727    |         |
| Hypothetical share repurchase at \$15.58                              |              | (252,563 ) |         |
| Earnings per common share – diluted                                   | \$ 5,541,000 | 12,178,099 | \$ 0.45 |

Stock options that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 84,144 shares in the three-month period ended March 31, 2012 and 226,426 shares in the three months ended March 31, 2011.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****3. COMPREHENSIVE INCOME**

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

|  | Before-Tax<br>Amount | Income Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|----------------------|----------------------|
| <b>Three Months Ended March 31, 2012</b>   |                      |                      |                      |
| Unrealized gains (losses) on available-for-sale securities:  |                      |                      |                      |
| Unrealized holding gains on available-for-sale securities  | \$ 344               | \$ (284 )            | \$ 60                |
| Reclassification adjustment for losses (gains) realized in income  | 2                    | (1 )                 | 1                    |
| Other comprehensive gain on available-for-sale securities  | 346                  | (285 )               | 61                   |
| Unfunded pension and postretirement obligations:   |                      |                      |                      |
| Change in items from defined benefit plans included in accumulated other comprehensive income                              | 200                  | (61 )                | 139                  |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 20                   | (6 )                 | 14                   |
| Other comprehensive gain on unfunded retirement obligations  | 220                  | (67 )                | 153                  |
| <b>Total other comprehensive income</b>  | <b>\$ 566</b>        | <b>\$ (352 )</b>     | <b>\$ 214</b>        |
| <b>Three Months Ended March 31, 2011</b>   |                      |                      |                      |
| Unrealized gains (losses) on available-for-sale securities:  |                      |                      |                      |
| Unrealized holding gains (losses) on available-for-sale securities   | \$ 6,125             | \$ (2,082 )          | \$ 4,043             |
| Reclassification adjustment for (gains) losses realized in income  | (1,839 )             | 625                  | (1,214 )             |
| Other comprehensive gain on available-for-sale securities  | 4,286                | (1,457 )             | 2,829                |
| Unfunded pension and postretirement obligations:   |                      |                      |                      |
| Change in items from defined benefit plans included in accumulated other comprehensive income                              | (119 )               | 40                   | (79 )                |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 13                   | (4 )                 | 9                    |
| Other comprehensive (loss) on unfunded retirement obligations  | (106 )               | 36                   | (70 )                |
| <b>Total other comprehensive income</b>  | <b>\$ 4,180</b>      | <b>\$ (1,421 )</b>   | <b>\$ 2,759</b>      |

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

|   | Unrealized<br>Holding Gains<br>on Securities | Unfunded<br>Retirement<br>Obligations | Accumulated<br>Other Comprehensive<br>Income (Loss) |
|---|--|---------------------------------------|---|
| Three Months Ended March 31, 2012               |  |                                       |   |
| Balance, beginning of period                    | \$ 10,791                                    | \$ (631 )                             | \$ 10,160   |
| Change during three months ended March 31, 2012 | 61   | 153                                   | 214   |
| Balance, end of period                          | \$ 10,852                                    | \$ (478 )                             | \$ 10,374   |
| Three Months Ended March 31, 2011               |  |                                       |   |
| Balance, beginning of period                    | \$ (1,351 )                                  | \$ (250 )                             | \$ (1,601 )   |
| Change during three months ended March 31, 2011 | 2,829  | (70 )                                 | 2,759   |
| Balance, end of period                          | \$ 1,478                                     | \$ (320 )                             | \$ 1,158  |



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

Cash and due from banks at March 31, 2012 and December 31, 2011 include the following:

| (In thousands)                | Mar. 31,<br>2012 | Dec. 31,<br>2011 |
|-------------------------------|------------------|------------------|
| Cash and cash equivalents     | \$52,258         | \$56,815         |
| Certificates of deposit       | 4,240            | 3,760            |
| Total cash and due from banks | \$56,498         | \$60,575         |

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

The Corporation is required to maintain reserves against deposit liabilities in the form of cash and balances with the Federal Reserve Bank. The reserves are based on deposit levels, account activity, and other services provided by the Federal Reserve Bank. Required reserves were \$14,059,000 at March 31, 2012 and \$14,035,000 at December 31, 2011.

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

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

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

available.

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

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

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

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At March 31, 2012 and December 31, 2011, assets measured at fair value and the valuation methods used are as follows:

| (In Thousands)  | March 31, 2012                                     |  |                                     | Total<br>Fair<br>Value |
|---|--|--|-------------------------------------|------------------------|
|   | Quoted Prices<br>in Active<br>Markets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) |                        |
| Recurring fair value measurements                                       |  |  |                                     |                        |
| <b>AVAILABLE-FOR-SALE SECURITIES:</b>                                   |  |  |                                     |                        |
| Obligations of U.S. Government agencies                                 | \$ 0   | \$25,488                                   | \$ 0                                | \$25,488               |
| Obligations of states and political subdivisions:                       |  |  |                                     |                        |
| Tax-exempt  | 0  | 133,337                                    | 0                                   | 133,337                |
| Taxable   | 0  | 17,206                                     | 0                                   | 17,206                 |
| Mortgage-backed securities  | 0  | 121,943                                    | 0                                   | 121,943                |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 0  | 165,764                                    | 0                                   | 165,764                |
| Trust preferred securities issued by individual institutions            | 0  | 8,147                                      | 0                                   | 8,147                  |
| Collateralized debt obligations:  |  |  |                                     |                        |
| Pooled trust preferred securities - senior tranches                     | 0  | 0  | 4,638                               | 4,638                  |
| Pooled trust preferred securities - mezzanine tranches                  | 0  | 0  | 782                                 | 782                    |
| Other collateralized debt obligations                                   | 0  | 660  | 0                                   | 660                    |
| Total debt securities   | 0  | 472,545                                    | 5,420                               | 477,965                |
| Marketable equity securities  | 8,699  | 0  | 0                                   | 8,699                  |
| Total available-for-sale securities                                     | 8,699  | 472,545                                    | 5,420                               | 486,664                |
| Servicing rights  | 0  | 0  | 409                                 | 409                    |
| Total recurring fair value measurements                                 | \$ 8,699   | \$472,545                                  | \$ 5,829                            | \$487,073              |
| Nonrecurring fair value measurements                                    |  |  |                                     |                        |
| Impaired loans with a valuation allowance                               | \$ 0   | \$0  | \$ 3,299                            | \$3,299                |
| Valuation allowance   | 0  | 0  | (1,126)                             | (1,126)                |
| Impaired loans, net   | 0  | 0  | 2,173                               | 2,173                  |
| Foreclosed assets held for sale   | 0  | 0  | 977                                 | 977                    |
| Total nonrecurring fair value measurements                              | \$ 0   | \$0  | \$ 3,150                            | \$3,150                |

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| (In Thousands)  | December 31, 2011                                  |  |                                     | Total<br>Fair<br>Value |
|---|--|--|-------------------------------------|------------------------|
|   | Quoted Prices<br>in Active<br>Markets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) |                        |
| Recurring fair value measurements                                       |  |  |                                     |                        |
| AVAILABLE-FOR-SALE SECURITIES:  |  |  |                                     |                        |
| Obligations of U.S. Government agencies                                 | \$ 0   | \$25,587                                   | \$ 0                                | \$25,587               |
| Obligations of states and political subdivisions:                       |  |  |                                     |                        |
| Tax-exempt  | 0  | 132,962                                    | 0                                   | 132,962                |
| Taxable   | 0  | 14,334                                     | 0                                   | 14,334                 |
| Mortgage-backed securities  | 0  | 121,769                                    | 0                                   | 121,769                |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 0  | 165,131                                    | 0                                   | 165,131                |
| Trust preferred securities issued by individual institutions            | 0  | 8,146                                      | 0                                   | 8,146                  |
| Collateralized debt obligations:  |  |  |                                     |                        |
| Pooled trust preferred securities - senior tranches                     | 0  | 0  | 4,638                               | 4,638                  |
| Pooled trust preferred securities - mezzanine tranches                  | 0  | 0  | 730                                 | 730                    |
| Other collateralized debt obligations                                   | 0  | 660  | 0                                   | 660                    |
| Total debt securities   | 0  | 468,589                                    | 5,368                               | 473,957                |
| Marketable equity securities  | 7,728  | 0  | 0                                   | 7,728                  |
| Total available-for-sale securities                                     | 7,728  | 468,589                                    | 5,368                               | 481,685                |
| Servicing rights  | 0  | 0  | 375                                 | 375                    |
| Total recurring fair value measurements                                 | \$ 7,728   | \$468,589                                  | \$ 5,743                            | \$482,060              |
| Nonrecurring fair value measurements                                    |  |  |                                     |                        |
| Impaired loans with a valuation allowance                               | \$ 0   | \$0  | \$ 3,433                            | \$3,433                |
| Valuation allowance   | 0  | 0  | (1,126 )                            | (1,126 )               |
| Impaired loans, net   | 0  | 0  | 2,307                               | 2,307                  |
| Foreclosed assets held for sale   | 0  | 0  | 1,235                               | 1,235                  |
| Total nonrecurring fair value measurements                              | \$ 0   | \$0  | \$ 3,542                            | \$3,542                |

Management determined there have been few trades of pooled trust-preferred securities since 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, the Corporation follows a method of valuing pooled trust-preferred securities using a Level 3 methodology, based on discounted cash flows.

Management has calculated the fair value of the Corporation's pooled trust-preferred securities by applying a discount rate to the estimated cash flows. Management used the cash flow estimates determined using the process described in Note 6 for evaluating pooled trust-preferred securities for other-than-temporary impairment (OTTI). Management used discount rates considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the securities. In establishing the discount rate, management considered: (1) the implied discount rates as of the end of 2007, prior to the market for trust-preferred securities becoming inactive; (2) adjustment to the year-end 2007 discount rates 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.

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

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Management's evaluation and selection of valuation techniques and the unobservable inputs used in determining the fair values of assets valued using Level 3 methodologies include sensitive assumptions. Other market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amount calculated by management. The following table shows quantitative information regarding significant techniques and inputs used at March 31, 2012 for assets measured using unobservable inputs (Level 3 methodologies) on a recurring basis:

| Asset  | Fair Value at 3/31/12 (In Thousands) | Valuation Technique  | Unobservable Input(s) | Value As of 3/31/12 | Method or Value As of 3/31/12   |
|--|--------------------------------------|----------------------|-----------------------|---------------------|---|
| Pooled trust preferred securities - senior tranches    | \$4,638                              | Discounted cash flow | Issuer defaults       | 37.69 %             | Actual Deferrals and Defaults as % of Outstanding Collateral                            |
|  |                                      |                      |                       | 13.21 %             | Expected Additional Net Deferrals and Defaults as % of Performing Collateral            |
|  |                                      |                      | Issuer prepayments    | 45.27 %             | Expected Issuer Prepayments as % of Performing Collateral                               |
|  |                                      |                      | Discount rate         | 11.70 %             | Implied 7.57% discount rate at 12/31/07 plus 4.13% spread for credit and liquidity risk |
| Pooled trust preferred securities - mezzanine tranches | 782                                  | Discounted cash flow | Issuer defaults       | 20.44 %             | Actual Deferrals and Defaults as % of Outstanding Collateral                            |
|  |                                      |                      |                       | 42.19 %             | Expected Additional Net Deferrals and Defaults as % of Performing Collateral            |
|  |                                      |                      | Future interest rates |                     | Three-month LIBOR forward curve   |
|  |                                      |                      | Issuer prepayments    | 0.00 %              | Expected Issuer Prepayments as % of Performing Collateral                               |
|  |                                      |                      | Discount rate         | 3.95 %              | Credit and liquidity risk spread added to three-month LIBOR forward curve               |

|                  |     |                      |                        |         |          |  |                                       |
|------------------|-----|----------------------|------------------------|---------|----------|--|---------------------------------------|
| Servicing rights | 409 | Discounted cash flow | Discount rate          | 9.00    | %        | Rate used through modeling period  |                                       |
|                  |     |                      | Loan prepayment speeds | 324.00  | %        | Weighted-average PSA   |                                       |
|                  |     |                      | Servicing fees         | 0.25    | %        | of loan balances   |                                       |
|                  |     |                      |                        | 5.00    | %        | of payments are late   |                                       |
|                  |     |                      |                        | 5.00    | %        | late fees assessed   |                                       |
|                  |     |                      |                        | \$ 1.94 |          | Miscellaneous fees per account per month   |                                       |
|                  |     |                      | Servicing costs        | \$ 5.50 |          | Monthly servicing cost per account   |                                       |
|                  |     |                      |                        |         | \$ 22.00 | Additional monthly servicing cost per loan on loans more than 30 days delinquent |                                       |
|                  |     |                      |                        |         | 1.00     | %  | of loans more than 30 days delinquent |
|                  |     |                      |                        |         | 3.50     | %  | annual increase in servicing costs    |

Increases (decreases) in actual or expected issuer defaults tend to decrease (increase) the fair value of the Corporation's senior and mezzanine tranches of pooled trust preferred securities. The values of the Corporation's mezzanine tranches of pooled trust preferred securities are also affected by expected future interest rates. However, due to the structure of each security, timing of cash flows, and secondary effects on the financial performance of the underlying issuers, the effects of changes in future interest rates on the fair value of the Corporation's holdings are not quantifiably estimable. The fair value of servicing rights is affected by expected future interest rates. Increases (decreases) in future expected interest rates tend to increase (decrease) the fair value of the Corporation's servicing rights because of changes in expected prepayment behavior by the borrowers on the underlying loans.

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

|   | Three Months Ended March 31, 2012                   |  |                  |          |
|---|---|--|------------------|----------|
|   | Pooled Trust Preferred Securities - Senior Tranches | Pooled Trust Preferred Securities - Mezzanine Tranches | Servicing Rights | Total    |
| Balance, beginning of period                            | \$ 4,638  | \$ 730   | \$ 375           | \$ 5,743 |
| Issuances of servicing rights                           | 0   | 0  | 55               | 55       |
| Accretion and amortization, net                         | (3 )  | 0  | 0                | (3 )     |
| Proceeds from sales and calls                           | 0   | (27 )  | 0                | (27 )    |
| Realized gains, net                                     | 0   | 27   | 0                | 27       |
| Unrealized losses included in earnings                  | 0   | 0  | (21 )            | (21 )    |
| Unrealized gains included in other comprehensive income | 3   | 52   | 0                | 55       |
| Balance, end of period                                  | \$ 4,638  | \$ 782   | \$ 409           | \$ 5,829 |

|   | Three Months Ended March 31, 2011                   |  |                  |          |
|---|---|--|------------------|----------|
|   | Pooled Trust Preferred Securities - Senior Tranches | Pooled Trust Preferred Securities - Mezzanine Tranches | Servicing Rights | Total    |
| Balance, beginning of period                            | \$ 7,400  | \$ 0   | \$ 204           | \$ 7,604 |
| Issuances of servicing rights                           | 0   | 0  | 102              | 102      |
| Accretion and amortization, net                         | (20 )   | 0  | 0                | (20 )    |
| Proceeds from sales and calls                           | 0   | (25 )  | 0                | (25 )    |
| Realized gains, net                                     | 0   | 25   | 0                | 25       |
| Unrealized losses included in earnings                  | 0   | 0  | (13 )            | (13 )    |
| Unrealized gains included in other comprehensive income | 1,658   | 0  | 0                | 1,658    |
| Balance, end of period                                  | \$ 9,038  | \$ 0   | \$ 293           | \$ 9,331 |

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



fair value of the Corporation.

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

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

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

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

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

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

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

**DEPOSITS** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable on demand at March 31, 2012 and December 31, 2011. The fair value of time deposits, such as certificates of deposit and Individual Retirement Accounts, is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates of deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

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

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

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

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

| (In Thousands)                   | Valuation Method(s) Used | March 31, 2012  |            | December 31, 2011 |            |
|----------------------------------|--------------------------|-----------------|------------|-------------------|------------|
|                                  |                          | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| Financial assets:                |                          |                 |            |                   |            |
| Cash and cash equivalents        | Level 1                  | \$52,258        | \$52,258   | \$56,815          | \$56,815   |
| Certificates of deposit          | Level 2                  | 4,240           | 4,254      | 3,760             | 3,683      |
| Available-for-sale securities    | See Above                | 486,664         | 486,664    | 481,685           | 481,685    |
| Restricted equity securities     | Level 2                  | 6,441           | 6,441      | 6,773             | 6,773      |
| Loans held for sale              | Level 1                  | 2,223           | 2,223      | 939               | 939        |
| Loans, net                       | Level 3                  | 690,218         | 709,596    | 700,610           | 718,274    |
| Accrued interest receivable      | Level 1                  | 4,943           | 4,943      | 4,797             | 4,797      |
| Servicing rights                 | Level 3                  | 409             | 409        | 375               | 375        |
| Financial liabilities:           |                          |                 |            |                   |            |
| Deposits with no stated maturity | Level 1                  | 680,746         | 680,746    | 677,461           | 677,461    |
| Time deposits                    | Level 3                  | 336,055         | 339,447    | 340,745           | 344,936    |
| Short-term borrowings            | Level 3                  | 4,030           | 3,989      | 4,950             | 4,897      |
| Long-term borrowings             | Level 3                  | 115,202         | 130,500    | 125,363           | 145,641    |
| Accrued interest payable         | Level 1                  | 245             | 245        | 358               | 358        |

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## 6. SECURITIES

Amortized cost and fair value of available-for-sale securities at March 31, 2012 and December 31, 2011 are summarized as follows:

| (In Thousands)  | Amortized<br>Cost | March 31, 2012                          |  | Fair<br>Value |
|---|-------------------|---|--|---------------|
|   |                   | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |               |
| Obligations of U.S. Government agencies                                 | \$ 24,810         | \$ 678                                  | \$ 0                                     | \$ 25,488     |
| Obligations of states and political subdivisions:                       |                   |   |  |               |
| Tax-exempt  | 128,628           | 5,356                                   | (647 )                                   | 133,337       |
| Taxable   | 16,846            | 402                                     | (42 )                                    | 17,206        |
| Mortgage-backed securities  | 117,251           | 4,704                                   | (12 )                                    | 121,943       |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 162,846           | 2,928                                   | (10 )                                    | 165,764       |
| Trust preferred securities issued by individual institutions            | 7,783             | 411                                     | (47 )                                    | 8,147         |
| Collateralized debt obligations:  |                   |   |  |               |
| Pooled trust preferred securities - senior tranches                     | 4,993             | 0                                       | (355 )                                   | 4,638         |
| Pooled trust preferred securities - mezzanine tranches                  | 0                 | 782                                     | 0  | 782           |
| Other collateralized debt obligations                                   | 660               | 0                                       | 0  | 660           |
| Total debt securities   | 463,817           | 15,261                                  | (1,113 )                                 | 477,965       |
| Marketable equity securities  | 6,151             | 2,569                                   | (21 )                                    | 8,699         |
| Total   | \$ 469,968        | \$ 17,830                               | \$ (1,134 )                              | \$ 486,664    |

| (In Thousands)                                    | Amortized<br>Cost | December 31, 2011                       |  | Fair<br>Value |
|---|-------------------|---|--|---------------|
|   |                   | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |               |
| Obligations of U.S. Government agencies           | \$ 24,877         | \$ 710                                  | \$ 0                                     | \$ 25,587     |
| Obligations of states and political subdivisions: |                   |   |  |               |
| Tax-exempt  | 129,401           | 4,891                                   | (1,330 )                                 | 132,962       |
| Taxable   | 14,004            | 334                                     | (4 )                                     | 14,334        |
| Mortgage-backed securities                        | 116,602           | 5,167                                   | 0  | 121,769       |
| Total   | 161,818           | 3,350                                   | (37 )                                    | 165,131       |

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|   |            |           |             |            |
|---|------------|-----------|-------------|------------|
| Collateralized mortgage obligations, Issued by U.S. Government agencies |            |           |             |            |
| Trust preferred securities issued by individual institutions            | 7,334      | 865       | (53 )       | 8,146      |
| Collateralized debt obligations:  |            |           |             |            |
| Pooled trust preferred securities - senior tranches                     | 4,996      | 0         | (358 )      | 4,638      |
| Pooled trust preferred securities - mezzanine tranches                  | 0          | 730       | 0           | 730        |
| Other collateralized debt obligations                                   | 660        | 0         | 0           | 660        |
| Total debt securities   | 459,692    | 16,047    | (1,782 )    | 473,957    |
| Marketable equity securities  | 5,643      | 2,186     | (101 )      | 7,728      |
| Total   | \$ 465,335 | \$ 18,233 | \$ (1,883 ) | \$ 481,685 |

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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 March 31, 2012 and December 31, 2011:

| March 31, 2012<br>(In Thousands)  | Less Than 12 Months<br>Fair<br>Value | Unrealized<br>Losses | 12 Months or More<br>Fair<br>Value | Unrealized<br>Losses | Total<br>Fair<br>Value | Unrealized<br>Losses |
|---|--------------------------------------|----------------------|------------------------------------|----------------------|------------------------|----------------------|
| Obligations of states and political subdivisions:                                       |                                      |                      |                                    |                      |                        |                      |
| Tax-exempt  | \$ 11,604                            | \$ (98 )             | \$ 9,488                           | \$ (549 )            | \$ 21,092              | \$ (647 )            |
| Taxable   | 1,701                                | (41 )                | 243                                | (1 )                 | 1,944                  | (42 )                |
| Mortgage-backed securities  | 10,406                               | (12 )                | 0                                  | 0                    | 10,406                 | (12 )                |
| Collateralized mortgage obligations, Issued by<br>U.S. Government agencies              | 4,485                                | (10 )                | 0                                  | 0                    | 4,485                  | (10 )                |
| Trust preferred securities issued by individual<br>institutions                         | 0                                    | 0                    | 953                                | (47 )                | 953                    | (47 )                |
| Collateralized debt obligations, Pooled trust<br>preferred securities - senior tranches | 0                                    | 0                    | 4,638                              | (355 )               | 4,638                  | (355 )               |
| Total debt securities   | 28,196                               | (161 )               | 15,322                             | (952 )               | 43,518                 | (1,113 )             |
| Marketable equity securities  | 241                                  | (17 )                | 86                                 | (4 )                 | 327                    | (21 )                |
| Total temporarily impaired available-for-sale<br>securities                             | \$ 28,437                            | \$ (178 )            | \$ 15,408                          | \$ (956 )            | \$ 43,845              | \$ (1,134 )          |
|   |                                      |                      |                                    |                      |                        |                      |
| December 31, 2011<br>(In Thousands)   | Less Than 12 Months<br>Fair<br>Value | Unrealized<br>Losses | 12 Months or More<br>Fair<br>Value | Unrealized<br>Losses | Total<br>Fair<br>Value | Unrealized<br>Losses |
| Obligations of states and political subdivisions:                                       |                                      |                      |                                    |                      |                        |                      |
| Tax-exempt  | \$ 4,301                             | \$ (34 )             | \$ 20,692                          | \$ (1,296 )          | \$ 24,993              | \$ (1,330 )          |
| Taxable   | 927                                  | (2 )                 | 244                                | (2 )                 | 1,171                  | (4 )                 |
| Collateralized mortgage obligations, Issued by<br>U.S. Government agencies              | 6,886                                | (36 )                | 5,075                              | (1 )                 | 11,961                 | (37 )                |
| Trust preferred securities issued by individual<br>institutions                         | 0                                    | 0                    | 947                                | (53 )                | 947                    | (53 )                |
| Collateralized debt obligations, Pooled trust<br>preferred securities - senior tranches | 0                                    | 0                    | 4,638                              | (358 )               | 4,638                  | (358 )               |
| Total debt securities   | 12,114                               | (72 )                | 31,596                             | (1,710 )             | 43,710                 | (1,782 )             |
| Marketable equity securities  | 776                                  | (44 )                | 98                                 | (57 )                | 874                    | (101 )               |
| Total temporarily impaired available-for-sale<br>securities                             | \$ 12,890                            | \$ (116 )            | \$ 31,694                          | \$ (1,767 )          | \$ 44,584              | \$ (1,883 )          |

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 |               |
|--|----------------|---------------|
|  | Mar. 31, 2012  | Mar. 31, 2011 |
| Gross realized gains                               | \$ 65          | \$ 1,840      |
| Gross realized losses                              | (67 )          | (1 )          |
| Net realized gains                                 | \$ (2 )        | \$ 1,839      |
| Income tax provision related to net realized gains | \$(1 )         | \$ 625        |

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.

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The amortized cost and fair value of available-for-sale debt securities by contractual maturity are shown in the following table as of March 31, 2012. Actual maturities may differ from contractual maturities because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands)  | Amortized<br>Cost | Fair<br>Value |
|---|-------------------|---------------|
| Due in one year or less   | \$ 9,072          | \$ 9,525      |
| Due from one year through five years                                    | 46,346            | 47,542        |
| Due from five years through ten years                                   | 27,782            | 28,421        |
| Due after ten years   | 100,520           | 104,770       |
| Subtotal  | 183,720           | 190,258       |
| Mortgage-backed securities  | 117,251           | 121,943       |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 162,846           | 165,764       |
| Total   | 463,817           | 477,965       |

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

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 an impairment loss in earnings of \$67,000 in the first quarter 2012, which was related to a bank stock. No impairment losses were recognized in the first quarter 2011.

A summary of information management considered in evaluating debt and equity securities for OTTI at March 31, 2012 is provided below.



## Debt Securities

At March 31, 2012, 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 March 31, 2012 to be temporary.

The credit rating agencies have withdrawn their ratings on numerous municipal bonds held by the Corporation. At March 31, 2012, the total amortized cost basis of municipal bonds with no external credit ratings was \$23,082,000, with an aggregate unrealized loss of \$65,000. 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, and most of the ratings were removed in the fourth quarter 2009. However, the insurance remains in effect on the bonds, and none of the affected municipal bonds has failed to make a scheduled interest payment.

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The following table provides information related to trust preferred securities issued by individual institutions as of March 31, 2012:

(In Thousands)

| Name of Issuer                     | Issuer's Parent Company       | Par Amount<br>Outstanding | Amortized Cost | Fair Value | Unrealized<br>Gain (Loss) | Realized<br>Credit<br>Losses | Moody's/<br>S&P/<br>Fitch |
|------------------------------------|-------------------------------|---------------------------|----------------|------------|---------------------------|------------------------------|---------------------------|
|                                    |                               |                           |                |            |                           |                              | Credit<br>Ratings         |
| Astoria Capital Trust I            | Astoria Financial Corporation | \$5,000                   | \$5,184        | \$5,194    | \$10                      | \$0                          | Baa3/BBB-                 |
| Carolina First Mortgage Loan Trust | The Toronto-Dominion Bank     | \$2,000                   | \$1,599        | \$2,000    | 401                       | (1,769)                      | NR                        |
| Patriot Capital Trust I            | Susquehanna Bancshares, Inc.  | \$1,000                   | \$1,000        | \$953      | (47)                      | 0                            | NR                        |
| Total                              |                               | \$8,000                   | \$7,783        | \$8,147    | \$364                     | \$(1,769)                    |                           |

(1) Astoria Capital Trust I is on negative outlook with Moody's.

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 accretion income totaling \$457,000 in the first quarter 2012 and \$111,000 in the first quarter 2011. For the year ended December 31, 2011, the Corporation recorded accretion income totaling \$825,000. 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 a lesser amount issued by insurance companies. Trust-preferred securities typically permit deferral of quarterly interest payments for up to five years, and 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. 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 three-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 the assumptions used could produce different conclusions for each security. Additional information regarding these assumptions is included in Note 5.

The following table provides detailed information related to pooled trust preferred securities – mezzanine tranches held as of March 31, 2012:

(In Thousands)

| Security                          | Tranche | Par Amount<br>Outstanding | Amortized<br>Cost | Fair<br>Value | Unrealized<br>Gain | Cumulative<br>OTTI |
|-----------------------------------|---------|---------------------------|-------------------|---------------|--------------------|--------------------|
| ALESCO Preferred Funding IX, Ltd. | C-1     | \$ 3,000                  | \$ 0              | \$ 0          | \$ 0               | \$ (2,988 )        |
| U.S. Capital Funding II, Ltd.     | B-1     | 2,000                     | 0                 | 313           | 313                | (1,992 )           |
| U.S. Capital Funding II, Ltd.     | B-2     | 3,000                     | 0                 | 469           | 469                | (2,973 )           |
| Total                             |         | \$ 8,000                  | \$ 0              | \$ 782        | \$ 782             | \$ (7,953 )        |

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As of March 31, 2012, the Corporation's investment in the senior tranche of MMCAPS Funding I, Ltd. had an investment grade rating. The security, with an amortized cost of \$4,993,000, 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 March 31, 2012.

The table that follows provides additional information related to pooled trust preferred securities as of March 31, 2012:

| Security   | MMCAPS<br>Funding I, Ltd. | U.S. Capital<br>Funding II, Ltd. | U.S. Capital<br>Funding II, Ltd. |
|--|---------------------------|----------------------------------|----------------------------------|
| Tranche  | Senior                    | B-1                              | B-2                              |
| Number of Banks Currently Performing   | 12                        | 36                               | 36                               |
| Moody's/Fitch Credit Ratings   | A3/BBB (1)                | Caa3/C                           | Caa3/C                           |
| Actual Deferrals and Defaults as % of Outstanding Collateral                 | 37.7 %                    | 20.4 %                           | 20.4 %                           |
| Expected Additional Net Deferrals and Defaults as % of Performing Collateral | 13.2 %                    | 42.2 %                           | 42.2 %                           |
| Excess Subordination as % of Performing Collateral                           | 40.7 %                    | -12.7 %                          | -12.7 %                          |
| Expected Issuer Prepayments as % of Performing Collateral                    | 45.3 %                    | 0.0 %                            | 0.0 %                            |

(1) 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 the Corporation's 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. A positive Excess Subordination Ratio signifies there is available support from subordinate tranches to absorb losses before the Corporation's investment would be impacted. A negative Excess Subordination Ratio signifies there is no available support from subordinate tranches to absorb losses before the Corporation's securities would be impacted. The Excess Subordination Ratio is not definitive, in isolation, for determining OTTI or whether the Corporation will receive future payments on a pooled trust preferred security. Other factors affect the timing and amount of cash flows available for payments to the note holders (investors), including the excess interest paid by the issuers, who typically pay higher rates of interest than are paid out to the note holders.

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 periods ended March 31, 2012 and 2011.

### **Equity Securities**

The Corporation's marketable equity securities at March 31, 2012 and December 31, 2011 consisted exclusively of stocks of banking companies. The Corporation recognized an impairment loss in earnings related to a bank stock of \$67,000 in the first quarter 2012. Management's decision to recognize an impairment loss on this security followed an evaluation of the issuer's published financial results in which management determined that the recovery of the Corporation's cost basis within the foreseeable future was uncertain. As a result of this determination, the Corporation recognized an impairment loss to write the stock down to the most recent trade price at March 31, 2012. The Corporation recognized no OTTI losses related to bank stocks in the first quarter 2011. At March 31, 2012, 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 other bank stock holdings at March 31, 2012 were other than temporarily impaired.

The Corporation did not sell any bank stocks or realize any gains or losses from sales of bank stocks during the first quarter 2012. Realized gains from sales of bank stocks totaled \$2,000 in the first quarter 2011 and included no transactions involving stocks for which OTTI had been previously recognized.

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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 \$6,311,000 at March 31, 2012 and \$6,643,000 at December 31, 2011. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at March 31, 2012 and December 31, 2011. 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.

**7. LOANS**

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

Loans outstanding at March 31, 2012 and December 31, 2011 are summarized as follows:

## Summary of Loans by Type

| (In Thousands)                            | Mar. 31,<br>2012 | % of<br>Total | Dec. 31,<br>2011 | % of<br>Total |
|---|------------------|---------------|------------------|---------------|
| <b>Residential mortgage:</b>              |                  |               |                  |               |
| Residential mortgage loans - first liens  | \$326,343        | 46.78 %       | \$331,015        | 46.73 %       |
| Residential mortgage loans - junior liens | 27,590           | 3.96 %        | 28,851           | 4.07 %        |
| Home equity lines of credit               | 30,534           | 4.38 %        | 30,037           | 4.24 %        |
| 1-4 Family residential construction       | 8,409            | 1.20 %        | 9,959            | 1.41 %        |
| Total residential mortgage                | 392,876          | 56.32 %       | 399,862          | 56.45 %       |
| <b>Commercial:</b>                        |                  |               |                  |               |
| Commercial loans secured by real estate   | 158,323          | 22.70 %       | 156,388          | 22.08 %       |
| Commercial and industrial                 | 54,370           | 7.79 %        | 57,191           | 8.07 %        |
| Political subdivisions                    | 36,517           | 5.23 %        | 37,620           | 5.31 %        |
| Commercial construction and land          | 23,577           | 3.38 %        | 23,518           | 3.32 %        |

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|                                      |           |        |   |           |        |   |
|--------------------------------------|-----------|--------|---|-----------|--------|---|
| Loans secured by farmland            | 10,334    | 1.48   | % | 10,949    | 1.55   | % |
| Multi-family (5 or more) residential | 6,326     | 0.91   | % | 6,583     | 0.93   | % |
| Agricultural loans                   | 2,982     | 0.43   | % | 2,987     | 0.42   | % |
| Other commercial loans               | 323       | 0.05   | % | 552       | 0.08   | % |
| Total commercial                     | 292,752   | 41.97  | % | 295,788   | 41.76  | % |
| Consumer                             | 11,960    | 1.71   | % | 12,665    | 1.79   | % |
| Total                                | 697,588   | 100.00 | % | 708,315   | 100.00 | % |
| Less: allowance for loan losses      | (7,370 )  |        |   | (7,705 )  |        |   |
| Loans, net                           | \$690,218 |        |   | \$700,610 |        |   |

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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 March 31, 2012 or December 31, 2011.

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 March 31, 2012 and December 31, 2011, management determined that no allowance for credit losses related to unfunded loan commitments was required.

Transactions within the allowance for loan losses, summarized by segment and class, for the three months ended March 31, 2012 and 2011 were as follows:

| (In Thousands)                            | December 31,<br>2011<br>Balance | Charge-<br>offs | Recoveries | Provision<br>(Credit) | March 31,<br>2012<br>Balance |
|---|---------------------------------|-----------------|------------|-----------------------|------------------------------|
| Allowance for Loan Losses:                |                                 |                 |            |                       |                              |
| Residential mortgage:                     |                                 |                 |            |                       |                              |
| Residential mortgage loans - first liens  | \$ 3,026                        | \$ (138 )       | \$ 0       | \$ 65                 | \$ 2,953                     |
| Residential mortgage loans - junior liens | 266                             | 0               | 0          | (6 )                  | 260                          |
| Home equity lines of credit               | 231                             | 0               | 0          | 1                     | 232                          |
| 1-4 Family residential construction       | 79                              | 0               | 0          | (17 )                 | 62                           |
| Total residential mortgage                | 3,602                           | (138 )          | 0          | 43                    | 3,507                        |
| Commercial:                               |                                 |                 |            |                       |                              |
| Commercial loans secured by real estate   | 2,004                           | 0               | 0          | (84 )                 | 1,920                        |
| Commercial and industrial                 | 946                             | 0               | 1          | (185 )                | 762                          |
| Political subdivisions                    | 0                               | 0               | 0          | 0                     | 0                            |
| Commercial construction and land          | 267                             | 0               | 0          | 58                    | 325                          |
| Loans secured by farmland                 | 126                             | 0               | 0          | (5 )                  | 121                          |



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|                                      |          |           |       |           |          |
|--------------------------------------|----------|-----------|-------|-----------|----------|
| Multi-family (5 or more) residential | 66       | 0         | 0     | (3 )      | 63       |
| Agricultural loans                   | 27       | 0         | 0     | 0         | 27       |
| Other commercial loans               | 5        | 0         | 0     | (2 )      | 3        |
| Total commercial                     | 3,441    | 0         | 1     | (221 )    | 3,221    |
| Consumer                             | 228      | (38 )     | 22    | (6 )      | 206      |
| Unallocated                          | 434      |           |       | 2         | 436      |
| Total Allowance for Loan Losses      | \$ 7,705 | \$ (176 ) | \$ 23 | \$ (182 ) | \$ 7,370 |

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| (In Thousands)                            | December 31,<br>2010 |                 |              | (Credit)<br>Provision | March 31,<br>2011 |
|---|----------------------|-----------------|--------------|-----------------------|-------------------|
|   | Balance              | Charge-offs     | Recoveries   |                       | Balance           |
| Allowance for Loan Losses:                |                      |                 |              |                       |                   |
| Residential mortgage:                     |                      |                 |              |                       |                   |
| Residential mortgage loans - first liens  | \$ 2,745             | \$ (1 )         |              | \$ 406                | \$ 3,150          |
| Residential mortgage loans - junior liens | 334                  | (51 )           |              | 22                    | 305               |
| Home equity lines of credit               | 218                  |                 |              | (6 )                  | 212               |
| 1-4 Family residential construction       | 208                  |                 |              | (146 )                | 62                |
| Total residential mortgage                | 3,505                | (52 )           | 0            | 276                   | 3,729             |
| Commercial:                               |                      |                 |              |                       |                   |
| Commercial loans secured by real estate   | 3,314                |                 |              | (196 )                | 3,118             |
| Commercial and industrial                 | 862                  |                 | 1            | (21 )                 | 842               |
| Political subdivisions                    | 0                    |                 |              | 0                     | 0                 |
| Commercial construction                   | 590                  |                 |              | (319 )                | 271               |
| Loans secured by farmland                 | 139                  |                 |              | 3                     | 142               |
| Multi-family (5 or more) residential      | 63                   |                 |              | 14                    | 77                |
| Agricultural loans                        | 32                   |                 |              | (3 )                  | 29                |
| Other commercial loans                    | 0                    |                 |              | 8                     | 8                 |
| Total commercial                          | 5,000                | 0               | 1            | (514 )                | 4,487             |
| Consumer                                  | 289                  | (45 )           | 27           | 4                     | 275               |
| Unallocated                               | 313                  |                 |              | 42                    | 355               |
| <b>Total Allowance for Loan Losses</b>    | <b>\$ 9,107</b>      | <b>\$ (97 )</b> | <b>\$ 28</b> | <b>\$ (192 )</b>      | <b>\$ 8,846</b>   |

In the evaluation of the loan portfolio, management determines two major components for the allowance for loan losses – (1) a specific component based on an assessment of certain larger relationships, mainly commercial purpose loans, on a loan-by-loan basis; and (2) a general component for the remainder of the portfolio based on a collective evaluation of pools of loans with similar risk characteristics. 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.

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The following tables summarize the aggregate credit quality classification of outstanding loans by risk rating as of March 31, 2012 and December 31, 2011:

March 31, 2012:

| (In Thousands)                            | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| Residential mortgage:                     |           |                    |             |          |           |
| Residential mortgage loans - first liens  | \$311,183 | \$2,517            | \$ 12,442   | \$ 201   | \$326,343 |
| Residential mortgage loans - junior liens | 26,033    | 636                | 921         | 0        | 27,590    |
| Home equity lines of credit               | 29,971    | 294                | 269         | 0        | 30,534    |
| 1-4 Family residential construction       | 8,409     | 0                  | 0           | 0        | 8,409     |
| Total residential mortgage                | 375,596   | 3,447              | 13,632      | 201      | 392,876   |
| Commercial:                               |           |                    |             |          |           |
| Commercial loans secured by real estate   | 144,964   | 7,743              | 5,616       | 0        | 158,323   |
| Commercial and industrial                 | 45,006    | 4,816              | 4,167       | 381      | 54,370    |
| Political subdivisions                    | 36,399    | 118                | 0           | 0        | 36,517    |
| Commercial construction and land          | 21,788    | 208                | 1,581       | 0        | 23,577    |
| Loans secured by farmland                 | 8,001     | 772                | 1,525       | 36       | 10,334    |
| Multi-family (5 or more) residential      | 5,950     | 363                | 13          | 0        | 6,326     |
| Agricultural loans                        | 2,895     | 29                 | 58          | 0        | 2,982     |
| Other commercial loans                    | 323       | 0                  | 0           | 0        | 323       |
| Total commercial                          | 265,326   | 14,049             | 12,960      | 417      | 292,752   |
| Consumer                                  | 11,758    | 20                 | 182         | 0        | 11,960    |
| Totals                                    | \$652,680 | \$ 17,516          | \$ 26,774   | \$ 618   | \$697,588 |

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December 31, 2011:

| (In Thousands)                            | Pass             | Special<br>Mention | Substandard      | Doubtful        | Total            |
|---|------------------|--------------------|------------------|-----------------|------------------|
| <b>Residential mortgage:</b>              |                  |                    |                  |                 |                  |
| Residential mortgage loans - first liens  | \$314,900        | \$2,955            | \$ 12,956        | \$ 204          | \$331,015        |
| Residential mortgage loans - junior liens | 27,260           | 660                | 924              | 7               | 28,851           |
| Home equity lines of credit               | 29,408           | 264                | 365              | 0               | 30,037           |
| 1-4 Family residential construction       | 9,959            | 0                  | 0                | 0               | 9,959            |
| Total residential mortgage                | 381,527          | 3,879              | 14,245           | 211             | 399,862          |
| <b>Commercial:</b>                        |                  |                    |                  |                 |                  |
| Commercial loans secured by real estate   | 143,247          | 7,385              | 5,046            | 710             | 156,388          |
| Commercial and industrial                 | 46,110           | 6,254              | 4,413            | 414             | 57,191           |
| Political subdivisions                    | 37,499           | 121                | 0                | 0               | 37,620           |
| Commercial construction and land          | 21,668           | 211                | 1,639            | 0               | 23,518           |
| Loans secured by farmland                 | 8,040            | 1,341              | 1,531            | 37              | 10,949           |
| Multi-family (5 or more) residential      | 6,200            | 369                | 14               | 0               | 6,583            |
| Agricultural loans                        | 2,765            | 164                | 58               | 0               | 2,987            |
| Other commercial loans                    | 552              | 0                  | 0                | 0               | 552              |
| Total commercial                          | 266,081          | 15,845             | 12,701           | 1,161           | 295,788          |
| Consumer                                  | 12,437           | 20                 | 207              | 1               | 12,665           |
| <b>Totals</b>                             | <b>\$660,045</b> | <b>\$ 19,744</b>   | <b>\$ 27,153</b> | <b>\$ 1,373</b> | <b>\$708,315</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 (residential mortgage, commercial and consumer) within the loan portfolio. Each qualitative factor is assigned a value to reflect improving, stable or declining conditions based on management's judgment using relevant information available at the time of the evaluation. Any adjustments to the factors are supported by a narrative documentation of changes in conditions accompanying the allowance for loan loss calculation.

The qualitative factors used in the general component calculations are designed to address credit risk characteristics associated with each segment. The Corporation's credit risk associated with all of the segments is significantly impacted by these factors, which include economic conditions within its market area, the Corporation's lending policies, changes or trends in the portfolio, risk profile, competition, regulatory requirements and other factors. Further, the residential mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation's commercial segment loans (approximately 68% at March 31,

2012) 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, all loans classified as troubled debt restructurings (discussed in more detail below) and all loan relationships less than \$200,000 in the aggregate, but with an estimated loss of \$100,000 or more, are individually evaluated for impairment. Loans that are individually evaluated for impairment, but which are not determined to be impaired, are combined with all remaining loans that are not reviewed on a specific basis, and such loans are included within larger pools of loans based on similar risk and loss characteristics for purposes of determining the general component of the allowance. The loans that have been individually evaluated, but which have not been determined to be impaired, are included in the “Collectively Evaluated” column in the tables summarizing the allowance and associated loan balances as of March 31, 2012 and December 31, 2011.

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 March 31, 2012 and December 31, 2011:

| March 31, 2012<br>(In Thousands)          | Individually<br>Evaluated | Collectively<br>Evaluated | Totals           |
|---|---------------------------|---------------------------|------------------|
| Loans:                                    |                           |                           |                  |
| Residential mortgage:                     |                           |                           |                  |
| Residential mortgage loans - first liens  | \$ 1,682                  | \$ 324,661                | \$326,343        |
| Residential mortgage loans - junior liens | 136                       | 27,454                    | 27,590           |
| Home equity lines of credit               | 0                         | 30,534                    | 30,534           |
| 1-4 Family residential construction       | 0                         | 8,409                     | 8,409            |
| Total residential mortgage                | 1,818                     | 391,058                   | 392,876          |
| Commercial:                               |                           |                           |                  |
| Commercial loans secured by real estate   | 2,042                     | 156,281                   | 158,323          |
| Commercial and industrial                 | 854                       | 53,516                    | 54,370           |
| Political subdivisions                    | 0                         | 36,517                    | 36,517           |
| Commercial construction and land          | 1,236                     | 22,341                    | 23,577           |
| Loans secured by farmland                 | 926                       | 9,408                     | 10,334           |
| Multi-family (5 or more) residential      | 12                        | 6,314                     | 6,326            |
| Agricultural loans                        | 40                        | 2,942                     | 2,982            |
| Other commercial loans                    | 0                         | 323                       | 323              |
| Total commercial                          | 5,110                     | 287,642                   | 292,752          |
| Consumer                                  | 49                        | 11,911                    | 11,960           |
| <b>Total Loans</b>                        | <b>\$ 6,977</b>           | <b>\$ 690,611</b>         | <b>\$697,588</b> |

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| March 31, 2012<br>(In Thousands)          | Individually<br>Evaluated | Collectively<br>Evaluated | Totals      |
|---|---------------------------|---------------------------|-------------|
| Allowance for Loan Losses:                |                           |                           |             |
| Residential mortgage:                     |                           |                           |             |
| Residential mortgage loans - first liens  | \$ 454                    | \$ 2,499                  | \$2,953     |
| Residential mortgage loans - junior liens | 8                         | 252                       | 260         |
| Home equity lines of credit               | 0                         | 232                       | 232         |
| 1-4 Family residential construction       | 0                         | 62                        | 62          |
| Total residential mortgage                | 462                       | 3,045                     | 3,507       |
| Commercial:                               |                           |                           |             |
| Commercial loans secured by real estate   | 154                       | 1,766                     | 1,920       |
| Commercial and industrial                 | 329                       | 433                       | 762         |
| Political subdivisions                    | 0                         | 0                         | 0           |
| Commercial construction and land          | 122                       | 203                       | 325         |
| Loans secured by farmland                 | 35                        | 86                        | 121         |
| Multi-family (5 or more) residential      | 0                         | 63                        | 63          |
| Agricultural loans                        | 0                         | 27                        | 27          |
| Other commercial loans                    | 0                         | 3                         | 3           |
| Total commercial                          | 640                       | 2,581                     | 3,221       |
| Consumer                                  | 24                        | 182                       | 206         |
| Unallocated                               |                           |                           | 436         |
| <br>Total Allowance for Loan Losses       | <br>\$ 1,126              | <br>\$ 5,808              | <br>\$7,370 |

| December 31, 2011<br>(In Thousands)       | Individually<br>Evaluated | Collectively<br>Evaluated | Totals    |
|---|---------------------------|---------------------------|-----------|
| Loans:                                    |                           |                           |           |
| Residential mortgage:                     |                           |                           |           |
| Residential mortgage loans - first liens  | \$ 2,227                  | \$ 328,788                | \$331,015 |
| Residential mortgage loans - junior liens | 137                       | 28,714                    | 28,851    |
| Home equity lines of credit               | 93                        | 29,944                    | 30,037    |
| 1-4 Family residential construction       | 0                         | 9,959                     | 9,959     |
| Total residential mortgage                | 2,457                     | 397,405                   | 399,862   |
| Commercial:                               |                           |                           |           |
| Commercial loans secured by real estate   | 2,169                     | 154,219                   | 156,388   |
| Commercial and industrial                 | 942                       | 56,249                    | 57,191    |
| Political subdivisions                    | 0                         | 37,620                    | 37,620    |
| Commercial construction and land          | 1,266                     | 22,252                    | 23,518    |
| Loans secured by farmland                 | 927                       | 10,022                    | 10,949    |
| Multi-family (5 or more) residential      | 14                        | 6,569                     | 6,583     |
| Agricultural loans                        | 39                        | 2,948                     | 2,987     |
| Other commercial loans                    | 0                         | 552                       | 552       |
| Total commercial                          | 5,357                     | 290,431                   | 295,788   |



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|             |          |            |           |
|-------------|----------|------------|-----------|
| Consumer    | 50       | 12,615     | 12,665    |
| Total Loans | \$ 7,864 | \$ 700,451 | \$708,315 |

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| December 31, 2011<br>(In Thousands)       | Individually<br>Evaluated | Collectively<br>Evaluated | Totals      |
|---|---------------------------|---------------------------|-------------|
| Allowance for Loan Losses:                |                           |                           |             |
| Residential mortgage:                     |                           |                           |             |
| Residential mortgage loans - first liens  | \$ 461                    | \$ 2,565                  | \$3,026     |
| Residential mortgage loans - junior liens | 11                        | 255                       | 266         |
| Home equity lines of credit               | 0                         | 231                       | 231         |
| 1-4 Family residential construction       | 0                         | 79                        | 79          |
| Total residential mortgage                | 472                       | 3,130                     | 3,602       |
| Commercial:                               |                           |                           |             |
| Commercial loans secured by real estate   | 169                       | 1,835                     | 2,004       |
| Commercial and industrial                 | 361                       | 585                       | 946         |
| Political subdivisions                    | 0                         | 0                         | 0           |
| Commercial construction and land          | 65                        | 202                       | 267         |
| Loans secured by farmland                 | 35                        | 91                        | 126         |
| Multi-family (5 or more) residential      | 0                         | 66                        | 66          |
| Agricultural loans                        | 0                         | 27                        | 27          |
| Other commercial loans                    | 0                         | 5                         | 5           |
| Total commercial                          | 630                       | 2,811                     | 3,441       |
| Consumer                                  | 24                        | 204                       | 228         |
| Unallocated                               |                           |                           | 434         |
| <br>Total Allowance for Loan Losses       | <br>\$ 1,126              | <br>\$ 6,145              | <br>\$7,705 |

Summary information related to impaired loans as of March 31, 2012 and December 31, 2011 is as follows:

| (In Thousands)                                | As of<br>Mar. 31,<br>2012 | As of<br>Dec. 31,<br>2011 |
|---|---------------------------|---------------------------|
| Impaired loans with a valuation allowance     | \$ 3,299                  | \$ 3,433                  |
| Impaired loans without a valuation allowance  | 3,678                     | 4,431                     |
| Total impaired loans                          | \$ 6,977                  | \$ 7,864                  |
| Valuation allowance related to impaired loans | \$ 1,126                  | \$ 1,126                  |

The average investment in impaired loans was \$7,120,000 for the three months ended March 31, 2012 compared to \$8,774,000 for the three months ended March 31, 2011. Interest income recognized on impaired loans was \$83,000 for the three months ended March 31, 2012 compared to \$50,000 for the three months ended March 31, 2011 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)                            | March 31, 2012                 |                 | December 31, 2011              |                 |
|---|--------------------------------|-----------------|--------------------------------|-----------------|
|   | Past Due 90+ Days and Accruing | Nonaccrual      | Past Due 90+ Days and Accruing | Nonaccrual      |
| <b>Residential mortgage:</b>              |                                |                 |                                |                 |
| Residential mortgage loans - first liens  | \$849                          | \$ 2,841        | \$ 949                         | \$ 3,058        |
| Residential mortgage loans - junior liens | 30                             | 66              | 11                             | 67              |
| Total residential mortgage                | 879                            | 2,907           | 960                            | 3,125           |
| <b>Commercial:</b>                        |                                |                 |                                |                 |
| Commercial loans secured by real estate   | 218                            | 1,573           | 75                             | 1,595           |
| Commercial and industrial                 | 35                             | 508             | 21                             | 541             |
| Commercial construction and land          | 111                            | 978             | 139                            | 978             |
| Loans secured by farmland                 | 0                              | 926             | 53                             | 927             |
| Agricultural loans                        | 5                              | 39              | 0                              | 0               |
| Total commercial                          | 369                            | 4,024           | 288                            | 4,041           |
| Consumer                                  | 4                              | 30              | 19                             | 31              |
| <b>Totals</b>                             | <b>\$1,252</b>                 | <b>\$ 6,961</b> | <b>\$ 1,267</b>                | <b>\$ 7,197</b> |

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

The table below presents a summary of the contractual aging of loans as of March 31, 2012 and December 31, 2011:

| (In Thousands)               | As of March 31, 2012                 |                     |                   |       |
|------------------------------|--------------------------------------|---------------------|-------------------|-------|
|                              | Current & Past Due Less than 30 Days | Past Due 30-89 Days | Past Due 90+ Days | Total |
| <b>Residential mortgage:</b> |                                      |                     |                   |       |

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|   |           |          |          |           |
|---|-----------|----------|----------|-----------|
| Residential mortgage loans - first liens  | \$319,866 | \$ 4,563 | \$ 1,914 | \$326,343 |
| Residential mortgage loans - junior liens | 27,309    | 241      | 40       | 27,590    |
| Home equity lines of credit               | 30,358    | 176      | 0        | 30,534    |
| 1-4 Family residential construction       | 8,409     | 0        | 0        | 8,409     |
| Total residential mortgage                | 385,942   | 4,980    | 1,954    | 392,876   |
| Commercial:                               |           |          |          |           |
| Commercial loans secured by real estate   | 156,656   | 518      | 1,149    | 158,323   |
| Commercial and industrial                 | 54,124    | 94       | 152      | 54,370    |
| Political subdivisions                    | 36,517    | 0        | 0        | 36,517    |
| Commercial construction and land          | 22,259    | 257      | 1,061    | 23,577    |
| Loans secured by farmland                 | 9,352     | 92       | 890      | 10,334    |
| Multi-family (5 or more) residential      | 6,236     | 90       | 0        | 6,326     |
| Agricultural loans                        | 2,938     | 0        | 44       | 2,982     |
| Other commercial loans                    | 323       | 0        | 0        | 323       |
| Total commercial                          | 288,405   | 1,051    | 3,296    | 292,752   |
| Consumer                                  | 11,829    | 127      | 4        | 11,960    |
| Totals                                    | \$686,176 | \$ 6,158 | \$ 5,254 | \$697,588 |

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| (In Thousands)                            | As of December 31, 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     |
| Residential mortgage:                     |   |                           |                         |           |
| Residential mortgage loans - first liens  | \$321,907                                     | \$ 6,723                  | \$ 2,385                | \$331,015 |
| Residential mortgage loans - junior liens | 28,437  | 393                       | 21                      | 28,851    |
| Home equity lines of credit               | 29,986  | 51                        | 0                       | 30,037    |
| 1-4 Family residential construction       | 9,959   | 0                         | 0                       | 9,959     |
| Total residential mortgage                | 390,289                                       | 7,167                     | 2,406                   | 399,862   |
| Commercial:                               |   |                           |                         |           |
| Commercial loans secured by real estate   | 155,025                                       | 343                       | 1,020                   | 156,388   |
| Commercial and industrial                 | 56,835  | 169                       | 187                     | 57,191    |
| Political subdivisions                    | 37,620  | 0                         | 0                       | 37,620    |
| Commercial construction and land          | 22,323  | 1,056                     | 139                     | 23,518    |
| Loans secured by farmland                 | 9,973   | 33                        | 943                     | 10,949    |
| Multi-family (5 or more) residential      | 6,583   | 0                         | 0                       | 6,583     |
| Agricultural loans                        | 2,945   | 3                         | 39                      | 2,987     |
| Other commercial loans                    | 552   | 0                         | 0                       | 552       |
| Total commercial                          | 291,856                                       | 1,604                     | 2,328                   | 295,788   |
| Consumer                                  | 12,340  | 306                       | 19                      | 12,665    |
| Totals                                    | \$694,485                                     | \$ 9,077                  | \$ 4,753                | \$708,315 |

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 March 31, 2012 and December 31, 2011 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   |
| March 31, 2012 Nonaccrual Totals    | \$ 2,628                         | \$ 331                    | \$ 4,002                | \$6,961 |
| December 31, 2011 Nonaccrual Totals | \$ 2,532                         | \$ 1,179                  | \$ 3,486                | \$7,197 |

Loans whose terms are modified are classified as Troubled Debt Restructurings (TDRs) if the Corporation grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Loans classified as

TDRs are designated as impaired. 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 provides guidance in evaluating whether a restructuring constitutes a TDR. The Update was effective for the Corporation in 2011, with retrospective application to January 1, 2011.

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The outstanding balance of loans subject to TDRs, as well as contractual aging information at March 31, 2012 and December 31, 2011 is as follows:

**Troubled Debt Restructurings (TDRs)**

| (In Thousands)           | Current &<br>Past Due<br>Less than<br>30 Days | Past Due<br>30-89<br>Days | Past Due<br>90+<br>Days | Nonaccrual | Total   |
|--------------------------|---|---------------------------|-------------------------|------------|---------|
| March 31, 2012 Totals    | \$ 960  | \$ 0                      | \$ 111                  | \$ 1,862   | \$2,933 |
| December 31, 2011 Totals | \$ 1,064                                      | \$ 0                      | \$ 146                  | \$ 2,267   | \$3,477 |

TDRs that occurred during the three-month period ended March 31, 2012 are as follows:

| Three Months Ended March 31, 2012<br>(Balances in Thousands) | Number<br>of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|--|---------------------------|---|--|
| Commercial,<br>Commercial and industrial                     | 1                         | \$ 65   | \$ 65  |

The TDR in the three-month period ended March 31, 2012 was an extension of the final maturity and lowering of monthly payments required on a commercial loan. There was no allowance for loan losses on this loan at March 31, 2012, and no change in the allowance for loan losses resulting from this TDR.

The outstanding balance of TDRs at December 31, 2011 included a balance of \$466,000 related to six commercial loans secured by real estate stemming from a forbearance agreement entered into with one commercial customer. Under the terms of the forbearance agreement, the Corporation had agreed to accept payment of less than the total principal amount of the loans, assuming payment was received by dates specified within the forbearance agreement. In the first quarter 2012, the loans were not repaid and the forbearance agreement expired. Accordingly, the Corporation's concession terminated, and the loans were not classified as TDRs at March 31, 2012. The outstanding balance of the loans was \$466,000 at March 31, 2012. The loans were in nonaccrual status at March 31, 2012 and December 31,



2011. At March 31, 2012, the risk rating of the loans was Substandard, while the risk rating of the loans was Doubtful at December 31, 2011. Based on management's estimate of the value of the underlying collateral, net of selling costs, the Corporation had no allowance for loan losses associated with these loans at March 31, 2012 and December 31, 2011.

Defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months are as follows:

| (Balances in Thousands)                         | Number<br>of<br>Contracts | Recorded<br>Investment |
|---|---------------------------|------------------------|
| Commercial,<br>Commercial construction and land | 1                         | \$ 950                 |

The event of default in the table above resulted from the borrowers' failure to make payments due at maturity, based on a loan maturity date that had been extended from the original due date. The allowance for loan losses on this loan was \$122,000 at March 31, 2012, an increase of \$57,000 over the allowance on the loan at December 31, 2011.

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****8. 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 March 31, 2012 and December 31, 2011, and are not expected to significantly affect the Corporation's future expenses. The Corporation uses a December 31 measurement date for the postretirement plan.

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

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

| Defined Benefit Plans<br>(In Thousands)       | Pension            |       | Postretirement     |       |
|---|--------------------|-------|--------------------|-------|
|   | Three Months Ended |       | Three Months Ended |       |
|   | March 31,<br>2012  | 2011  | March 31,<br>2012  | 2011  |
| Service cost                                  | \$ 0               | \$ 0  | \$ 23              | \$ 21 |
| Interest cost                                 | 18                 | 18    | 20                 | 23    |
| Expected return on plan assets                | (18 )              | (18 ) | 0                  | 0     |
| Amortization of transition (asset) obligation | 0                  | 0     | 9                  | 9     |
| Amortization of prior service cost            | 0                  | 0     | 4                  | 3     |
| Recognized net actuarial loss                 | 7                  | 1     | 0                  | 0     |
| Net periodic benefit cost                     | \$ 7               | \$ 1  | \$ 56              | \$ 56 |

In the first three months of 2012, the Corporation funded postretirement contributions totaling \$15,000, with estimated annual postretirement contributions of \$60,000 expected in 2012 for the full year. The Corporation made a contribution to the defined benefit pension plan of \$21,000 in the first quarter of 2012 for the 2011 plan year. Based upon the related actuarial reports, the Corporation made a \$23,000 contribution in the second quarter 2012 for the 2012 plan year. No further contributions are expected in 2012.

**9. STOCK-BASED COMPENSATION PLANS**

In January 2012, the Corporation granted options to purchase a total of 64,757 shares of common stock through its Stock Incentive and Independent Directors Stock Incentive Plans. In January 2011, the Corporation granted options to purchase a total of 93,674 shares of common stock. The exercise price for the 2012 awards is \$18.54 per share, and the exercise price for the 2011 awards is \$15.06 per share, based on the market price as of the date of grant. Stock option expense is recognized over the vesting period of each option. The Corporation expects total stock option expense for the year ending December 31, 2012 to be \$247,000, and total stock option expense for the year ended December 31, 2011 was \$279,000.

The Corporation records stock option expense based on estimated fair value calculated using an option valuation model. In calculating the 2012 and 2011 fair values, the Corporation utilized the Black-Scholes-Merton option-pricing model. The calculated fair value of each option granted, and significant assumptions used in the calculations, are as follows:

|                                   | 2012    |   | 2011    |   |
|-----------------------------------|---------|---|---------|---|
| Fair value of each option granted | \$5.15  |   | \$4.26  |   |
| Volatility                        | 41      | % | 37      | % |
| Expected option lives             | 7 Years |   | 8 Years |   |
| Risk-free interest rate           | 1.53    | % | 3.10    | % |
| Dividend yield                    | 3.97    | % | 3.86    | % |

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In calculating the estimated fair value of 2012 and 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 expected option lives were based on management's estimates of the average term for all options issued under both plans. In 2012 and 2011, 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 2012, the Corporation awarded a total of 42,552 shares of restricted stock under the Stock Incentive and Independent Directors Stock Incentive Plans. In January 2011, a total of 15,622 shares of restricted stock were awarded under the Plans. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. For 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 three months of 2012 based on an assumption that the ROAE target for 2012 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)   | 3 Months Ended |                |
|------------------|----------------|----------------|
|                  | March 31, 2012 | March 31, 2011 |
| Stock options    | \$ 159         | \$ 156         |
| Restricted stock | 82             | 36             |
| Total            | \$ 241         | \$ 192         |

**10. INCOME TAXES**

The net deferred tax asset at March 31, 2012 and December 31, 2011 represents the following temporary difference components:

| (In Thousands)                          | March 31,<br>2012 | December 31,<br>2011 |
|---|-------------------|----------------------|
| Deferred tax assets:                    |                   |                      |
| Defined benefit plans - ASC 835         | \$ 257            | \$ 324               |
| Net realized losses on securities       | 3,048             | 3,175                |
| Allowance for loan losses               | 2,579             | 2,697                |
| Credit for alternative minimum tax paid | 4,576             | 4,569                |
| Capital loss carryforwards              | 44                | 44                   |
| General business credit carryforwards   | 233               | 831                  |
| Other deferred tax assets               | 1,628             | 1,671                |
| Total deferred tax assets               | 12,365            | 13,311               |
| Deferred tax liabilities:               |                   |                      |
| Unrealized holding gains on securities  | 5,844             | 5,559                |
| Bank premises and equipment             | 1,314             | 1,357                |
| Core deposit intangibles                | 68                | 74                   |
| Other deferred tax liabilities          | 136               | 148                  |
| Total deferred tax liabilities          | 7,362             | 7,138                |
| Deferred tax asset, net                 | \$ 5,003          | \$ 6,173             |

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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 March 31, 2012. Of the total deferred tax asset from realized losses on securities, \$332,000 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 \$130,000 capital loss carryforward at March 31, 2012, expiring in 2015. The Corporation has available, unused tax credits of \$233,000 at March 31, 2012 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 2029 through 2031.

The provision for income tax for the three-month periods ended March 31, 2012 and 2011 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:

| (In thousands)                     | Three Months Ended |              |
|------------------------------------|--------------------|--------------|
|                                    | March 31,          |              |
|                                    | 2012               | 2011         |
|                                    | (Current)          | (Prior Year) |
| Income before income tax provision | \$ 7,696           | \$ 7,605     |
| Income tax provision               | 2,109              | 2,064        |
| Effective tax rate                 | 27.40 %            | 27.14 %      |

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. With limited exceptions, the Corporation is no longer subject to examination by the Internal Revenue Service for years prior to 2008.

**11. 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. In addition to the limited partnership investment, the Corporation has a loan receivable from the limited partnership with an outstanding balance of \$1,032,000 at March 31, 2012. 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.

## **12. CONTINGENCIES**

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

## **13. RECENT ACCOUNTING PRONOUNCEMENTS**

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

In 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 was 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. Note 7 provides disclosures required by this standard.

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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. There were no changes in the Corporation’s procedures for determining fair value measurements as a result of this Update, however additional quantitative disclosures about unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy are provided. The amendments in this ASU are applied prospectively, and Note 5 includes disclosures required by this ASU.

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 includes 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 is 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 are applied retrospectively, and the Corporation has adopted the two statement approach as reflected in the accompanying financial statements.

In September 2011, the FASB issued ASU No. 2011-08, Intangibles – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment. The amendments in this ASU permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, and management adopted this ASU in assessing goodwill for impairment as of December 31, 2011.



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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.

### **EARNINGS OVERVIEW**

Net income available to common shareholders for the first quarter 2012 was \$5,587,000, or \$0.46 per basic and diluted share. The first quarter 2012 return on average assets was 1.72%, and the return on average equity was 13.15%. First quarter 2012 earnings were down from fourth quarter 2011 earnings of \$6,141,000, or \$0.51 per basic and diluted share. First quarter 2012 earnings were up slightly as compared to first quarter 2011 earnings of \$5,541,000, or \$0.46 per basic share and \$0.45 per diluted share.

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

First quarter 2012 net interest income was \$120,000 (1.0%) lower than in the fourth quarter 2011, and \$992,000 (8.8%) higher than in the first quarter 2011. Although the interest margin improved to 4.41% in the first quarter 2012 as compared to 4.33% in the fourth quarter 2011, the most recent quarterly net interest income was impacted by a 1.2% lower average volume of earning assets. The higher level of net interest income in the first quarter 2012 as compared to first quarter 2011 reflected significant improvement in the margin, which was up from 4.05% in the first quarter 2011, primarily because of a lower cost of funds. Net interest income includes the benefit of accretion from the offset of a previous write-down on a security, with a benefit of \$457,000 recorded in the most recent quarter, up from \$325,000 in the fourth quarter 2011 and \$111,000 in the first quarter 2011. This security matures in May 2012, and assuming the Corporation holds it until maturity, accretion of \$398,000 would be recorded in the second quarter 2012, with no accretion on the security thereafter.

The provision for loan losses was a credit (reduction in expense) of \$182,000 in the first quarter 2012, as compared to a credit of \$87,000 in the fourth quarter 2011 and a credit of \$192,000 in the first quarter 2011. The credits for loan losses in 2012 and 2011 have resulted, in part, from a reduction in loans outstanding, as the general component of the allowance for loan losses was reduced. In the first quarter 2012, the credit included a reduction in a component of the allowance for loan losses that is determined based on the 3 previous years' net charge-off experience. In recent years, the Corporation has experienced a limited amount of loan-related credit problems, as compared to averages for comparable-sized peer banks.

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Total noninterest revenue, excluding losses or gains from available-for-sale securities, was \$3,759,000 in the first quarter 2012, up slightly over the fourth quarter 2011 total of \$3,711,000 and up from \$2,555,000 in the first quarter 2011. In 2011, noninterest revenue was negatively impacted by an impairment loss in the first quarter of \$948,000 related to an investment in a real estate limited partnership.

In the first quarter 2012, net losses from available-for-sale securities were \$2,000, down from gains of \$188,000 in the fourth quarter 2011 and considerably lower than gains of \$1,839,000 in the first quarter 2011. In the most recent quarter, the Corporation had realized gains from securities totaling \$65,000, but recorded an other-than-temporary-impairment loss of \$67,000 on an investment in a bank stock. 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.

Total noninterest expense was \$8,517,000 in the first quarter 2012, up \$569,000 over the fourth quarter 2011, and up \$254,000 (3.1%) over the first quarter 2011. A portion of the reason for the higher expenses in the first quarter 2012 as compared to the fourth quarter 2011 is timing-related, as payroll taxes and some other employee benefit costs are typically higher in the first quarter than in the remainder of the year. This is reflected in pensions and other benefit expenses, which totaled \$1,366,000 in the most recent quarter, up \$303,000 over the fourth quarter 2011 and up \$60,000 over the first quarter 2011. Other operating expense, a category that includes many different types of expenses, totaled \$1,980,000 in the most recent quarter, up \$203,000 over the fourth quarter 2011 and \$284,000 over the first quarter 2011. Within other operating expense, first quarter 2012 expenses for director stock options, business development and postage were higher than in the fourth quarter 2011. The largest increases in other operating expense in the most recent quarter as compared to the first quarter 2011 were from software subscriptions and updates, postage and expenses related to other real estate properties. FDIC assessments totaled \$146,000 in the most recent quarter, in line with the fourth quarter 2011 and considerably lower than the first quarter 2011 expense of \$325,000. Effective in the second quarter 2011, the FDIC changed its method for determining assessments, which helped to reduce the amounts charged to the Corporation, and improvements in the Corporation's financial data also had a favorable impact on the amounts assessed.

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

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

|                                    | Mar. 31,<br>2012 | Dec 31,<br>2011 | Sept. 30,<br>2011 | June 30,<br>2011 | Mar. 31,<br>2011 |
|------------------------------------|------------------|-----------------|-------------------|------------------|------------------|
| Interest income                    | \$14,776         | \$15,198        | \$15,317          | \$15,443         | \$15,298         |
| Interest expense                   | 2,502            | 2,804           | 3,108             | 3,628            | 4,016            |
| Net interest income                | 12,274           | 12,394          | 12,209            | 11,815           | 11,282           |
| (Credit) provision for loan losses | (182 )           | (87 )           | (37 )             | 31               | (192 )           |

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|  |         |         |         |         |         |
|--|---------|---------|---------|---------|---------|
| Net Interest income after (credit) provision for loan losses | 12,456  | 12,481  | 12,246  | 11,784  | 11,474  |
| Other income   | 3,759   | 3,711   | 3,999   | 3,673   | 2,555   |
| Net (losses) gains on available-for-sale securities          | (2 )    | 188     | 26      | 163     | 1,839   |
| Other expenses   | 8,517   | 7,948   | 8,052   | 7,794   | 8,263   |
| Income before income tax provision                           | 7,696   | 8,432   | 8,219   | 7,826   | 7,605   |
| Income tax provision   | 2,109   | 2,291   | 2,230   | 2,129   | 2,064   |
| Net income available to common shareholders                  | \$5,587 | \$6,141 | \$5,989 | \$5,697 | \$5,541 |
| Net income per common share – basic                          | \$0.46  | \$0.51  | \$0.49  | \$0.47  | \$0.46  |
| Net income per common share – diluted                        | \$0.46  | \$0.51  | \$0.49  | \$0.47  | \$0.45  |

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.

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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 7 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 5 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.

As described in Note 6 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 periods ended March 31, 2012 and March 31, 2011. 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.

For the three-month periods, fully taxable equivalent net interest income was \$13,123,000 in 2012, \$1,038,000 (8.6%) higher than in 2011. As shown in Table IV, net changes in volume had the effect of increasing net interest income \$271,000 in 2012 compared to 2011, and interest rate changes had the effect of increasing net interest income \$767,000. The most significant components of the volume change in net interest income in 2012 were a decrease in interest expense of \$292,000 attributable to a reduction in the balance of borrowed funds, a decrease in interest expense of \$186,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit and Individual Retirement Accounts), and a decrease in interest income of \$260,000 attributable to a decline in the balance of loans receivable. The most significant components of the rate change in net interest income in 2012 were a decrease in interest expense of \$1,032,000 due to lower rates paid on interest-bearing deposits and a decrease in interest income of \$205,000 attributable to lower rates earned on loans receivable. 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 4.17% in 2012, as compared to 3.77% in 2011.

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### INTEREST INCOME AND EARNING ASSETS

Interest income totaled \$15,625,000 in 2012, a decrease of 3.0% from 2011. Interest and fees on loans receivable decreased \$465,000, or 4.1%. As indicated in Table III, average available-for-sale securities (at amortized cost) totaled \$458,736,000 in 2012, an increase of \$4,659,000 (1.0%) from 2011. Net growth in the Corporation's taxable available-for-sale securities portfolio was primarily made up of U.S. Government agency collateralized mortgage obligations and mortgage-backed securities and also included a significant increase in the balance of taxable municipal securities. This growth was partially offset by a reduction in the balance of U.S. Government agency bonds and pooled trust preferred securities. The Corporation's yield on taxable securities fell in 2011 and 2012 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 4.08% for 2012 and 4.16% in 2011.

The average balance of gross loans receivable decreased 2.8% to \$702,154,000 in 2012 from \$722,326,000 in 2011. The Corporation experienced contraction in the balance of loans receivable due to borrowers prepaying or refinancing existing loans combined with modest demand for new loans. The decline in the balance of the residential mortgage portfolio was also affected by management's decision to sell a portion of newly originated residential mortgages on the secondary market. The Corporation's average rate of return on loans receivable declined to 6.27% in 2012 from 6.40% in 2011 as rates on new loans as well as existing, variable-rate loans have decreased.

The average balance of interest-bearing due from banks increased to \$34,334,000 in 2012 from \$31,750,000 in 2011. 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 2011 and 2012 (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. During the fourth quarter 2011, the Corporation began investing in FDIC-insured certificates of deposit issued by other financial institutions and maturing within five years; these investments averaged \$4,090,000 for 2012 and totaled \$4,240,000 at March 31, 2012. The Corporation held no such investments in the first quarter 2011 or in prior periods.

### INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell \$1,514,000, or 37.7%, to \$2,502,000 in 2012 from \$4,016,000 in 2011. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 1.08% in 2012 from 1.63% in 2011.

Total average deposits (interest-bearing and noninterest-bearing) decreased 0.2%, to \$1,000,304,000 in 2012 from \$1,002,017,000 in 2011. Decreases in the average balance of certificates of deposit and Individual Retirement Accounts were partially offset by increases in demand deposits and savings accounts. Consistent with continuing low short-term market interest rates, the average rates incurred on deposit accounts have decreased significantly in 2012 as compared to 2011.

Variable-rate accounts comprised \$135,106,000 of the average balance in Individual Retirement Accounts in 2012 and \$150,570,000 in 2011. 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; following this change, the rate paid on these accounts was lowered several times and was 0.75% at March 31, 2012. As shown in Table III, the average rate on Individual Retirement Accounts decreased to 0.96% in 2012 from 2.99% in 2011.

Total average borrowed funds decreased \$39,638,000 to \$123,029,000 in 2012 from \$162,667,000 in 2011. During 2011 and 2012, the Corporation has paid off long-term borrowings as they matured using the cash flow received from loans and investment securities. The average balance of "RepoSweep" arrangements, which are used by the Corporation to borrow funds from commercial banking customers on an overnight basis and included within short-term borrowings, declined to \$4,015,000 in 2012 from \$16,865,000 in 2011 primarily as a result of changes to service charges assessed on related business checking accounts. In the first quarter 2012, the Corporation took two short-term advances from the Federal Home Loan Bank of Pittsburgh (FHLB) to offset seasonal declines in deposit balances. Short-term advances averaged \$3,407,000 in 2012 with no such advances outstanding during 2011. The short-term advances matured during the first quarter 2012, and none were outstanding at March 31, 2012. The average rate on borrowed funds was 3.77% in 2012, compared to 3.61% in 2011.



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TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE

| (In Thousands)                      | Three Months<br>Ended |          | Increase/<br>(Decrease) |
|-------------------------------------|-----------------------|----------|-------------------------|
|                                     | March 31,<br>2012     | 2011     |                         |
| <b>INTEREST INCOME</b>              |                       |          |                         |
| Available-for-sale securities:      |                       |          |                         |
| Taxable                             | \$2,733               | \$2,755  | \$ (22 )                |
| Tax-exempt                          | 1,916                 | 1,905    | 11                      |
| Total available-for-sale securities | 4,649                 | 4,660    | (11 )                   |
| Interest-bearing due from banks     | 28                    | 16       | 12                      |
| Loans held for sale                 | 9                     | 21       | (12 )                   |
| Loans receivable:                   |                       |          |                         |
| Taxable                             | 10,366                | 10,847   | (481 )                  |
| Tax-exempt                          | 573                   | 557      | 16                      |
| Total loans receivable              | 10,939                | 11,404   | (465 )                  |
| Total Interest Income               | 15,625                | 16,101   | (476 )                  |
| <b>INTEREST EXPENSE</b>             |                       |          |                         |
| Interest-bearing deposits:          |                       |          |                         |
| Interest checking                   | 51                    | 130      | (79 )                   |
| Money market                        | 97                    | 151      | (54 )                   |
| Savings                             | 26                    | 56       | (30 )                   |
| Certificates of deposit             | 826                   | 1,041    | (215 )                  |
| Individual Retirement Accounts      | 350                   | 1,189    | (839 )                  |
| Other time deposits                 | 0                     | 1        | (1 )                    |
| Total interest-bearing deposits     | 1,350                 | 2,568    | (1,218 )                |
| Borrowed funds:                     |                       |          |                         |
| Short-term                          | 3                     | 6        | (3 )                    |
| Long-term                           | 1,149                 | 1,442    | (293 )                  |
| Total borrowed funds                | 1,152                 | 1,448    | (296 )                  |
| Total Interest Expense              | 2,502                 | 4,016    | (1,514 )                |
| Net Interest Income                 | \$13,123              | \$12,085 | \$ 1,038                |

Note: Interest income from tax-exempt securities and loans has been adjusted to a fully tax-equivalent basis, using the Corporation's marginal federal income tax rate of 35% in 2012 and 34% in 2011.



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Table III - Analysis of Average Daily Balances and Rates

(Dollars in Thousands)

|   | 3 Months<br>Ended<br>3/31/2012<br>Average<br>Balance | Rate of<br>Return/<br>Cost of<br>Funds % |  | 3 Months<br>Ended<br>3/31/2011<br>Average<br>Balance | Rate of<br>Return/<br>Cost of<br>Funds % |  |
|---|--|--|--|--|--|--|
| <b>EARNING ASSETS</b>                             |  |  |  |  |  |  |
| Available-for-sale securities, at amortized cost: |  |  |  |  |  |  |
| Taxable   | \$331,007  | 3.32 %                                   |  | \$327,104  | 3.42 %                                   |  |
| Tax-exempt  | 127,729  | 6.03 %                                   |  | 126,973  | 6.08 %                                   |  |
| Total available-for-sale securities               | 458,736  | 4.08 %                                   |  | 454,077  | 4.16 %                                   |  |
| Interest-bearing due from banks                   | 34,334   | 0.33 %                                   |  | 31,750   | 0.20 %                                   |  |
| Loans held for sale                               | 1,057  | 3.42 %                                   |  | 1,722  | 4.95 %                                   |  |
| Loans receivable:                                 |  |  |  |  |  |  |
| Taxable   | 665,936  | 6.26 %                                   |  | 687,253  | 6.40 %                                   |  |
| Tax-exempt  | 36,218   | 6.36 %                                   |  | 35,073   | 6.44 %                                   |  |
| Total loans receivable                            | 702,154  | 6.27 %                                   |  | 722,326  | 6.40 %                                   |  |
| Total Earning Assets                              | 1,196,281  | 5.25 %                                   |  | 1,209,875  | 5.40 %                                   |  |
| Cash  | 16,891   |  |  | 16,985   |  |  |
| Unrealized gain/loss on securities                | 17,923   |  |  | (588 )   |  |  |
| Allowance for loan losses                         | (7,739 )   |  |  | (9,201 )   |  |  |
| Bank premises and equipment                       | 18,898   |  |  | 22,474   |  |  |
| Intangible Asset - Core Deposit Intangible        | 204  |  |  | 315  |  |  |
| Intangible Asset - Goodwill                       | 11,942   |  |  | 11,942   |  |  |
| Other assets                                      | 48,282   |  |  | 60,758   |  |  |
| Total Assets                                      | \$1,302,682  |  |  | \$1,312,560  |  |  |
| <b>INTEREST-BEARING LIABILITIES</b>               |  |  |  |  |  |  |
| Interest-bearing deposits:                        |  |  |  |  |  |  |
| Interest checking                                 | \$161,524  | 0.13 %                                   |  | \$163,479  | 0.32 %                                   |  |
| Money market                                      | 205,866  | 0.19 %                                   |  | 203,439  | 0.30 %                                   |  |
| Savings   | 104,532  | 0.10 %                                   |  | 92,625   | 0.25 %                                   |  |
| Certificates of deposit                           | 191,924  | 1.73 %                                   |  | 212,133  | 1.99 %                                   |  |
| Individual Retirement Accounts                    | 146,241  | 0.96 %                                   |  | 161,174  | 2.99 %                                   |  |
| Other time deposits                               | 942  | 0.00 %                                   |  | 956  | 0.42 %                                   |  |
| Total interest-bearing deposits                   | 811,029  | 0.67 %                                   |  | 833,806  | 1.25 %                                   |  |
| Borrowed funds:                                   |  |  |  |  |  |  |
| Short-term  | 7,422  | 0.16 %                                   |  | 16,865   | 0.14 %                                   |  |
| Long-term   | 115,607  | 4.00 %                                   |  | 145,802  | 4.01 %                                   |  |

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|   |             |      |   |             |      |   |
|---|-------------|------|---|-------------|------|---|
| Total borrowed funds  | 123,029     | 3.77 | % | 162,667     | 3.61 | % |
| Total Interest-bearing Liabilities                              | 934,058     | 1.08 | % | 996,473     | 1.63 | % |
| Demand deposits   | 189,275     |      |   | 168,211     |      |   |
| Other liabilities   | 9,452       |      |   | 6,461       |      |   |
| Total Liabilities   | 1,132,785   |      |   | 1,171,145   |      |   |
| Stockholders' equity, excluding other comprehensive income/loss | 158,801     |      |   | 142,054     |      |   |
| Other comprehensive income/loss                                 | 11,096      |      |   | (639)       |      |   |
| Total Stockholders' Equity                                      | 169,897     |      |   | 141,415     |      |   |
| Total Liabilities and Stockholders' Equity                      | \$1,302,682 |      |   | \$1,312,560 |      |   |
| Interest Rate Spread  |             | 4.17 | % |             | 3.77 | % |
| Net Interest Income/Earning Assets                              |             | 4.41 | % |             | 4.05 | % |
| <br>  |             |      |   |             |      |   |
| Total Deposits (Interest-bearing and Demand)                    | \$1,000,304 |      |   | \$1,002,017 |      |   |

(1) Rates of return on tax-exempt securities and loans are presented on a fully taxable-equivalent basis, using the Corporation's marginal federal income tax rate of 35% in 2012 and 34% in 2011.

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

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

| (In Thousands)                      | 3 Months Ended 3/31/12 vs. 3/31/11 |                   |                 |
|-------------------------------------|------------------------------------|-------------------|-----------------|
|                                     | Change<br>in<br>Volume             | Change in<br>Rate | Total<br>Change |
| <b>EARNING ASSETS</b>               |                                    |                   |                 |
| Available-for-sale securities:      |                                    |                   |                 |
| Taxable                             | \$ 40                              | \$ (62 )          | \$ (22 )        |
| Tax-exempt                          | 18                                 | (7 )              | 11              |
| Total available-for-sale securities | 58                                 | (69 )             | (11 )           |
| Interest-bearing due from banks     | 1                                  | 11                | 12              |
| Loans held for sale                 | (6 )                               | (6 )              | (12 )           |
| Loans receivable:                   |                                    |                   |                 |
| Taxable                             | (282 )                             | (199 )            | (481 )          |
| Tax-exempt                          | 22                                 | (6 )              | 16              |
| Total loans receivable              | (260 )                             | (205 )            | (465 )          |
| Total Interest Income               | (207 )                             | (269 )            | (476 )          |
| <b>INTEREST-BEARING LIABILITIES</b> |                                    |                   |                 |
| Interest-bearing deposits:          |                                    |                   |                 |
| Interest checking                   | (2 )                               | (77 )             | (79 )           |
| Money market                        | 2                                  | (56 )             | (54 )           |
| Savings                             | 6                                  | (36 )             | (30 )           |
| Certificates of deposit             | (91 )                              | (124 )            | (215 )          |
| Individual Retirement Accounts      | (101 )                             | (738 )            | (839 )          |
| Other time deposits                 | 0                                  | (1 )              | (1 )            |
| Total interest-bearing deposits     | (186 )                             | (1,032 )          | (1,218 )        |
| Borrowed funds:                     |                                    |                   |                 |
| Short-term                          | (4 )                               | 1                 | (3 )            |
| Long-term                           | (288 )                             | (5 )              | (293 )          |
| Total borrowed funds                | (292 )                             | (4 )              | (296 )          |
| Total Interest Expense              | (478 )                             | (1,036 )          | (1,514 )        |
| Net Interest Income                 | \$ 271                             | \$ 767            | \$ 1,038        |

(1) Changes in income on tax-exempt securities and loans are presented on a fully tax-equivalent basis, using the Corporation's marginal federal income tax rate of 35% in 2012 and 34% in 2011.

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

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****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 147.03%. The security has a face amount of \$2,000,000, matures in May 2012, and has an interest rate which adjusts quarterly based on three-month LIBOR. The security had an amortized cost of \$1,599,000 and a fair value of \$2,000,000 at March 31, 2012.

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 (Actual)    | 229                        |
| 4th Quarter 2011 (Actual)    | 325                        |
| 1st Quarter 2012 (Actual)    | 457                        |
| 2nd Quarter 2012 (Estimated) | 398                        |
| Total                        | \$ 1,763                   |

**TABLE V – COMPARISON OF NONINTEREST INCOME**

**(In Thousands)**

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|   | 3 Months  |         |         |         |
|---|-----------|---------|---------|---------|
|   | Ended     |         | \$      | %       |
|   | March 31, | 2011    |         |         |
|   | 2012      | 2011    |         |         |
| Service charges on deposit accounts   | \$1,161   | \$1,131 | \$30    | 2.7     |
| Service charges and fees  | 220       | 218     | 2       | 0.9     |
| Trust and financial management revenue  | 929       | 877     | 52      | 5.9     |
| Brokerage revenue   | 168       | 123     | 45      | 36.6    |
| Insurance commissions, fees and premiums  | 34        | 68      | (34 )   | (50.0 ) |
| Interchange revenue from debit card transactions  | 495       | 452     | 43      | 9.5     |
| Net gains from sales of loans   | 265       | 259     | 6       | 2.3     |
| Increase in cash surrender value of life insurance  | 119       | 122     | (3 )    | (2.5 )  |
| Net gain (loss) from other real estate  | 104       | (19 )   | 123     | (647.4) |
| Impairment loss on limited partnership investment   | 0         | (948 )  | 948     | (100.0) |
| Other operating income  | 264       | 272     | (8 )    | (2.9 )  |
| Total other operating income before realized (losses) gains on available-for-sale securities, net | \$3,759   | \$2,555 | \$1,204 | 47.1    |



**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****NONINTEREST INCOME - THREE MONTHS ENDED MARCH 31, 2012 AND 2011**

Table V excludes realized gains and 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 increased \$1,204,000 or 47.1%, in the first quarter 2012 as compared to the first quarter 2011. The most significant variances 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. In addition to the limited partnership investment, the Corporation has a loan receivable from the limited partnership of \$1,032,000 at March 31, 2012. 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.

Net gains from sales of real estate acquired from foreclosures (other real estate) amounted to \$104,000 in the first quarter 2012 as compared to a loss of \$19,000 in the first quarter 2011. The Corporation recognized a gain (not adjusted for prior loan charge-off and foregone interest income amounts) of \$93,000 in the first quarter 2012 on the sale of a commercial property that had a carrying value in foreclosed assets held for sale of \$765,000 at December 31, 2011.

**TABLE VI – COMPARISON OF NONINTEREST EXPENSE****(In Thousands)**

|                                      | 3 Months Ended |                | \$     | %       |
|--------------------------------------|----------------|----------------|--------|---------|
|                                      | March 31, 2012 | March 31, 2011 |        |         |
| Salaries and wages                   | \$3,575        | \$3,401        | \$ 174 | 5.1     |
| Pensions and other employee benefits | 1,366          | 1,306          | 60     | 4.6     |
| Occupancy expense, net               | 636            | 732            | (96 )  | (13.1 ) |
| Furniture and equipment expense      | 482            | 484            | (2 )   | (0.4 )  |
| FDIC Assessments                     | 146            | 325            | (179 ) | (55.1 ) |
| Pennsylvania shares tax              | 332            | 319            | 13     | 4.1     |
| Other operating expense              | 1,980          | 1,696          | 284    | 16.7    |

|                     |         |         |        |     |
|---------------------|---------|---------|--------|-----|
| Total Other Expense | \$8,517 | \$8,263 | \$ 254 | 3.1 |
|---------------------|---------|---------|--------|-----|

**NONINTEREST EXPENSE - THREE MONTHS ENDED MARCH 31, 2012 AND 2011**

As shown in Table VI, total noninterest expense increased \$254,000 or 3.1% in the first quarter 2012 as compared to the first quarter 2011. Significant variances include the following:

Salaries and wages increased \$174,000, or 5.1%. In addition to the impact of annual merit-based salary increases, the number of employees has increased slightly over the past few quarters, mainly with the addition of lending-related personnel. The Corporation employed 291 full-time equivalent employees in March 2012, up from 286 in March 2011.

Pensions and other employee benefits increased \$60,000, or 4.6%, including an increase of \$69,000 in group health insurance expense.

Occupancy expense decreased \$96,000, or 13.1%. Within this category, snow removal and related expenses were \$44,000 lower in 2012, reflecting the milder winter weather throughout the Corporation's market area. Depreciation expense was \$43,000 lower in 2012, mainly due to the impact of the sale of the Court Street, Williamsport property in the third quarter 2011. In connection with the sale, the Corporation entered into a lease arrangement to continue to use a portion of the building. The lease is accounted for as an operating lease. Management estimates that total building-related expenses (including the effects of lower depreciation referred to above) for this location were \$40,000 lower in the first quarter 2012 than in the first quarter 2011.

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FDIC Assessments decreased \$179,000, or 55.1%. Effective April 1, 2011, the FDIC’s method of determining assessments to banks changed, with the new methodology resulting in higher assessments to larger, more complex or higher-risk institutions, and smaller assessments to many community and small regional banks. The Corporation’s estimated first quarter 2012 FDIC assessment is substantially lower than the first quarter 2011 amount, reflecting the new methodology. The favorable decline also reflects rate changes attributed to improvements in the Corporation’s risk profile based on financial ratios.

Other operating expense increased \$284,000, or 16.7%. This category includes many different types of expenses, with the most significant differences in amounts between the first quarter 2012 and 2011 as follows:

- Ø Software-related subscriptions and updates, mainly related to lending-related activities, up \$74,000, or 50.9%
- Ø Postage, up \$43,000, or 41.7%
- Ø Expenses associated with other real estate properties, up \$41,000
- Ø Stock option expense for Independent Directors, up \$37,000, reflecting higher awards in January 2012 based on 2011 performance
- Ø Fees paid related to interchange and ATM processing, up \$32,000, or 13.2%
- Ø Advertising expense, up \$27,000, or 35.3%, and
- Ø Professional fees, up \$25,000, or 28.6%.

**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 2012.

**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 7 to the

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

While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to 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 of \$7,370,000 at March 31, 2012 was down from \$7,705,000 at December 31, 2011. Table VIII shows that the specific allowance on impaired loans totaled \$1,126,000 at March 31, 2012, which was the same total as at December 31, 2011. There were changes in the allowance amounts on some of the individual impaired loans; however, the changes were not significant, with the largest change an increase in the allowance of \$57,000 on one loan. Table VIII also shows that the collectively determined components of the allowance fell by a total of \$337,000 as of March 31, 2012 compared to December 31, 2011, including a decrease related to commercial loans of \$230,000. The collectively determined allowance fell in the most recent quarter, in part, because total outstanding loans decreased for each segment of the portfolio. Also, for the commercial segment, the net charge-off percentage used to determine a portion of the collectively determined allowance was lower in the first quarter 2012 as compared to the percentage used throughout 2011. (The Corporation uses net charge-offs as a percentage of average outstanding loans for the previous three calendar years to estimate a portion of the collectively determined allowance.) The net charge-off percentages did not change significantly for the residential mortgage and consumer segments, and the qualitative factors used in determining the collectively evaluated components of the allowance did not change significantly at March 31, 2012 as compared to December 31, 2011.

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As shown in Table VII, the Corporation recorded a credit for loan losses of \$182,000 for the first quarter 2012 and a credit for loan losses of \$192,000 for the first quarter 2011. The credit for loan losses in the first quarter 2012 reflected the reduction in the collectively determined portion of the allowance for loan losses, mainly due to lower outstanding loan balances and the lower average 3-year net charge-off factor for commercial loans, as described above. In the first quarter 2011, the credit for loan losses included the impact of a reduction in the allowance on impaired loans, as a loan was paid off in full for which the Corporation had established a specific allowance of \$150,000 at December 31, 2010. Also, collectively determined allowances were lower at March 31, 2011 than at December 31, 2010 as a result of lower outstanding loan balances. 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 7 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 the first quarter 2012 and 2011.

Table IX presents information related to past due and impaired loans, and loans that have been modified under terms that are considered troubled debt restructurings (TDRs). Virtually all of the amounts presented in Table IX were lower at March 31, 2012 as compared to December 31, 2011, including a significant improvement in total loans past due 30-89 days and still accruing interest, mainly due to a lower amount of past due residential mortgage loans. Each period presented in Table IX 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.

As shown in Table IX, loans classified as TDRs were significantly higher at March 31, 2012 and December 31, 2011 as compared to the previous year-end balances presented. The increase in TDRs reflects the impact of the (ASU 2011-02) accounting guidance which became effective in 2011, as modifications such as extensions of terms and maturities that would have not been considered TDRs in the past (because the contractual interest rate had not been changed) are now considered TDRs because the current (un-modified) contractual rate would be considered less than a market rate for the applicable borrower.

The outstanding balance of TDRs at December 31, 2011 included a balance of \$466,000 related to six commercial loans secured by real estate stemming from a forbearance agreement entered into with one commercial customer. Under the terms of the forbearance agreement, the Corporation had agreed to accept payment of less than the total principal amount of the loans, assuming payment was received by dates specified within the forbearance agreement. In the first quarter 2012, the loans were not repaid and the forbearance agreement expired. Accordingly, the Corporation's concession terminated, and the loans were not classified as TDRs at March 31, 2012. The outstanding balance of the loans was \$466,000 at March 31, 2012. The loans were in nonaccrual status at March 31, 2012 and December 31, 2011. At March 31, 2012, the risk rating of the loans was Substandard, while the risk rating of the loans was Doubtful at December 31, 2011. Based on management's estimate of the value of the underlying collateral, net of selling costs,

the Corporation had no allowance for loan losses associated with these loans at March 31, 2012 and December 31, 2011.

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 March 31, 2012. 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.

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

|   | 3 Months Ended    |                   |                          |         |         |         |         |
|---|-------------------|-------------------|--------------------------|---------|---------|---------|---------|
|   | March 31,<br>2012 | March 31,<br>2011 | Years Ended December 31, |         |         |         | 2007    |
|   | 2011              | 2010              | 2009                     | 2008    | 2007    |         |         |
| Balance, beginning of year                        | \$7,705           | \$ 9,107          | \$9,107                  | \$8,265 | \$7,857 | \$8,859 | \$8,201 |
| Charge-offs:                                      |                   |                   |                          |         |         |         |         |
| Residential mortgage                              | (138 )            | (52 )             | (100 )                   | (340 )  | (146 )  | (173 )  | (149 )  |
| Commercial  | 0                 | 0                 | (1,189)                  | (91 )   | (39 )   | (1,607) | (174 )  |
| Consumer  | (38 )             | (45 )             | (157 )                   | (188 )  | (293 )  | (259 )  | (221 )  |
| Total charge-offs                                 | (176 )            | (97 )             | (1,446)                  | (619 )  | (478 )  | (2,039) | (544 )  |
| Recoveries:                                       |                   |                   |                          |         |         |         |         |
| Residential mortgage                              | 0                 | 0                 | 3                        | 55      | 8       | 19      | 5       |
| Commercial  | 1                 | 1                 | 255                      | 113     | 77      | 22      | 31      |
| Consumer  | 22                | 27                | 71                       | 102     | 121     | 87      | 50      |
| Total recoveries                                  | 23                | 28                | 329                      | 270     | 206     | 128     | 86      |
| Net charge-offs                                   | (153 )            | (69 )             | (1,117)                  | (349 )  | (272 )  | (1,911) | (458 )  |
| Allowance for loan losses recorded in acquisition | 0                 | 0                 | 0                        | 0       | 0       | 0       | 587     |
| (Credit) provision for loan losses                | (182 )            | (192 )            | (285 )                   | 1,191   | 680     | 909     | 529     |
| Balance, end of period                            | \$7,370           | \$ 8,846          | \$7,705                  | \$9,107 | \$8,265 | \$7,857 | \$8,859 |

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

|                                | As of<br>March<br>31, | As of December 31, |         |         |       |         |
|--------------------------------|-----------------------|--------------------|---------|---------|-------|---------|
|                                | 2012                  | 2011               | 2010    | 2009    | 2008  | 2007    |
| ASC 310 - Impaired loans       | \$1,126               | \$1,126            | \$2,288 | \$1,126 | \$456 | \$2,255 |
| ASC 450 - Collective segments: |                       |                    |         |         |       |         |
| Commercial                     | 2,581                 | 2,811              | 3,047   | 2,677   | 2,654 | 1,870   |
| Residential mortgage           | 3,045                 | 3,130              | 3,227   | 3,859   | 3,920 | 4,201   |
| Consumer                       | 182                   | 204                | 232     | 281     | 399   | 533     |
| Unallocated                    | 436                   | 434                | 313     | 322     | 428   | 0       |

|                 |         |         |         |         |         |         |
|-----------------|---------|---------|---------|---------|---------|---------|
| Total Allowance | \$7,370 | \$7,705 | \$9,107 | \$8,265 | \$7,857 | \$8,859 |
|-----------------|---------|---------|---------|---------|---------|---------|



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

|   | As of<br>March 31,<br>2012 | As of December 31,<br>2011 | 2010     | 2009    | 2008    | 2007     |
|---|----------------------------|----------------------------|----------|---------|---------|----------|
| Impaired loans with a valuation allowance               | \$ 3,299                   | \$3,433                    | \$5,457  | \$2,690 | \$2,230 | \$5,361  |
| Impaired loans without a valuation allowance            | 3,678                      | 4,431                      | 3,191    | 3,257   | 3,435   | 857      |
| Total impaired loans                                    | \$ 6,977                   | \$7,864                    | \$8,648  | \$5,947 | \$5,665 | \$6,218  |
| Total loans past due 30-89 days and still accruing      | \$ 5,827                   | \$7,898                    | \$7,125  | \$9,445 | \$9,875 | \$10,822 |
| Nonperforming assets:                                   |                            |                            |          |         |         |          |
| Total nonaccrual loans                                  | \$ 6,961                   | \$7,197                    | \$10,809 | \$9,092 | \$7,200 | \$6,955  |
| Total loans past due 90 days or more and still accruing | 1,252                      | 1,267                      | 727      | 31      | 1,305   | 1,200    |
| Foreclosed assets held for sale (real estate)           | 977                        | 1,235                      | 537      | 873     | 298     | 258      |
| Total nonperforming assets                              | \$ 9,190                   | \$9,699                    | \$12,073 | \$9,996 | \$8,803 | \$8,413  |
| Total nonperforming assets as a % of assets             | 0.70 %                     | 0.73 %                     | 0.92 %   | 0.76 %  | 0.69 %  | 0.66 %   |
| Loans subject to troubled debt restructurings (TDRs):   |                            |                            |          |         |         |          |
| Performing  | \$ 960                     | \$1,064                    | \$645    | \$326   | \$0     | \$0      |
| Nonperforming   | 1,973                      | 2,413                      | 0        | 0       | 0       | 0        |
| Total TDRs  | \$ 2,933                   | \$3,477                    | \$645    | \$326   | \$0     | \$0      |

**CITIZENS & NORTHERN CORPORATION – FORM 10-Q****TABLE X - SUMMARY OF LOANS BY TYPE****Summary of Loans by Type****(In Thousands)**

|   | March<br>31,<br>2012 | As of December 31, |           |           |           |           |
|---|----------------------|--------------------|-----------|-----------|-----------|-----------|
|   | 2011                 | 2010               | 2009      | 2008      | 2007      |           |
| <b>Residential mortgage:</b>              |                      |                    |           |           |           |           |
| Residential mortgage loans - first liens  | \$326,343            | \$331,015          | \$333,012 | \$340,268 | \$353,909 | \$363,467 |
| Residential mortgage loans - junior liens | 27,590               | 28,851             | 31,590    | 35,734    | 40,657    | 40,392    |
| Home equity lines of credit               | 30,534               | 30,037             | 26,853    | 23,577    | 21,304    | 20,542    |
| 1-4 Family residential construction       | 8,409                | 9,959              | 14,379    | 11,452    | 11,262    | 4,742     |
| Total residential mortgage                | 392,876              | 399,862            | 405,834   | 411,031   | 427,132   | 429,143   |
| <b>Commercial:</b>                        |                      |                    |           |           |           |           |
| Commercial loans secured by real estate   | 158,323              | 156,388            | 167,094   | 163,483   | 165,979   | 144,742   |
| Commercial and industrial                 | 54,370               | 57,191             | 59,005    | 49,753    | 48,295    | 52,241    |
| Political subdivisions                    | 36,517               | 37,620             | 36,480    | 37,598    | 38,790    | 33,013    |
| Commercial construction                   | 23,577               | 23,518             | 24,004    | 15,264    | 13,730    | 17,755    |
| Loans secured by farmland                 | 10,334               | 10,949             | 11,353    | 11,856    | 9,140     | 8,287     |
| Multi-family (5 or more) residential      | 6,326                | 6,583              | 7,781     | 8,338     | 8,367     | 9,004     |
| Agricultural loans                        | 2,982                | 2,987              | 3,472     | 3,848     | 4,495     | 3,553     |
| Other commercial loans                    | 323                  | 552                | 392       | 638       | 884       | 1,010     |
| Total commercial                          | 292,752              | 295,788            | 309,581   | 290,778   | 289,680   | 269,605   |
| Consumer                                  | 11,960               | 12,665             | 14,996    | 19,202    | 26,732    | 37,193    |
| Total                                     | 697,588              | 708,315            | 730,411   | 721,011   | 743,544   | 735,941   |
| Less: allowance for loan losses           | (7,370 )             | (7,705 )           | (9,107 )  | (8,265 )  | (7,857 )  | (8,859 )  |
| Loans, net                                | \$690,218            | \$700,610          | \$721,304 | \$712,746 | \$735,687 | \$727,082 |

**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 March 31, 2012, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$33,236,000.

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 \$27,119,000 at March 31, 2012.

The Corporation's outstanding, available, and total credit facilities at March 31, 2012 and December 31, 2011 are as follows:

|                                      | Outstanding      |                  | Available        |                  | Total Credit     |                  |
|--------------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
|                                      | Mar. 31,<br>2012 | Dec. 31,<br>2011 | Mar. 31,<br>2012 | Dec. 31,<br>2011 | Mar. 31,<br>2012 | Dec. 31,<br>2011 |
| <b>(In Thousands)</b>                |                  |                  |                  |                  |                  |                  |
| Federal Home Loan Bank of Pittsburgh | \$30,202         | \$40,363         | \$295,333        | \$292,304        | \$325,535        | \$332,667        |
| Federal Reserve Bank Discount Window | 0                | 0                | 26,049           | 27,438           | 26,049           | 27,438           |
| Other correspondent banks            | 0                | 0                | 45,000           | 25,000           | 45,000           | 25,000           |
| Total credit facilities              | \$30,202         | \$40,363         | \$366,382        | \$344,742        | \$396,584        | \$385,105        |

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At March 31, 2012 and December 31, 2011, 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 available-for-sale securities to meet its obligations. At March 31, 2012, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was \$237,602,000.

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

**STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY**

The Corporation and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning capital ratios at March 31, 2012 and December 31, 2011 are presented below. Management believes, as of March 31, 2012 and December 31, 2011, that the Corporation and C&N Bank meet all capital adequacy requirements to which they are subject.

| (Dollars in Thousands)                  | Actual    |        | Minimum Capital Requirement |                 | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |                  |
|---|-----------|--------|-----------------------------|-----------------|--|------------------|
|   | Amount    | Ratio  | Amount                      | Ratio           | Amount   | Ratio            |
| March 31, 2012:                         |           |        |                             |                 |  |                  |
| Total capital to risk-weighted assets:  |           |        |                             |                 |  |                  |
| Consolidated                            | \$155,294 | 22.01% | \$56,450                    | <sup>38</sup> % | n/a  | n/a              |
| C&N Bank                                | 142,682   | 20.45% | 55,805                      | <sup>38</sup> % | \$ 69,756  | <sup>310</sup> % |
| Tier 1 capital to risk-weighted assets: |           |        |                             |                 |  |                  |
| Consolidated                            | 146,778   | 20.80% | 28,225                      | <sup>34</sup> % | n/a  | n/a              |
| C&N Bank                                | 135,238   | 19.39% | 28,902                      | <sup>34</sup> % | 41,854   | <sup>36</sup> %  |
| Tier 1 capital to average assets:       |           |        |                             |                 |  |                  |
| Consolidated                            | 146,778   | 11.50% | 51,052                      | <sup>34</sup> % | n/a  | n/a              |
| C&N Bank                                | 135,238   | 10.68% | 50,671                      | <sup>34</sup> % | 63,339   | <sup>35</sup> %  |

December 31, 2011:

Total capital to risk-weighted assets:

|              |           |        |          |               |   |           |                  |
|--------------|-----------|--------|----------|---------------|---|-----------|------------------|
| Consolidated | \$149,898 | 21.17% | \$56,636 | <sup>38</sup> | % | n/a       | n/a              |
| C&N Bank     | 137,717   | 19.66% | 56,046   | <sup>38</sup> | % | \$ 70,058 | <sup>310</sup> % |

Tier 1 capital to risk-weighted assets:

|              |         |        |        |               |   |        |                 |
|--------------|---------|--------|--------|---------------|---|--------|-----------------|
| Consolidated | 141,255 | 19.95% | 28,318 | <sup>34</sup> | % | n/a    | n/a             |
| C&N Bank     | 129,978 | 18.55% | 28,023 | <sup>34</sup> | % | 42,035 | <sup>36</sup> % |

Tier 1 capital to average assets:

|              |         |        |        |               |   |        |                 |
|--------------|---------|--------|--------|---------------|---|--------|-----------------|
| Consolidated | 141,255 | 10.93% | 51,712 | <sup>34</sup> | % | n/a    | n/a             |
| C&N Bank     | 129,978 | 10.14% | 51,285 | <sup>34</sup> | % | 64,107 | <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.

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

The Corporation's total stockholders' equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in "Accumulated Other Comprehensive Income (Loss)" within stockholders' equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains on available-for-sale securities, net of deferred income tax, amounted to \$10,852,000 at March 31, 2012 and \$10,791,000 at December 31, 2011. 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 6 to the consolidated financial statements provides additional information concerning management's evaluation of available-for-sale securities for other-than-temporary impairment at March 31, 2012.

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 (\$478,000) at March 31, 2012 and (\$631,000) at December 31, 2011.

## **COMPREHENSIVE INCOME**

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. Accordingly, the Corporation has included Statements of Comprehensive Income in the unaudited consolidated financial statements for the three-month periods ended March 31, 2012 and 2011.

Comprehensive Income is the total of (1) net income, and (2) all other changes in equity from non-stockholder sources, which are referred to as Other Comprehensive Income. Changes in the components of Accumulated Other Comprehensive Income (Loss) are included in Other Comprehensive Income, and for the Corporation, consist of changes in unrealized gains or losses on available-for-sale securities and changes in underfunded defined benefit plans. Comprehensive Income totaled \$5,801,000 in the first quarter 2012 and \$8,300,000 in the first quarter 2011. Although net income was slightly higher for the first quarter 2012 than in the first quarter 2011, Comprehensive Income was higher in the first quarter 2011 because the amount of unrealized gains on available-for-sale securities, net of deferred income tax, was \$2,829,000 as compared to \$61,000 in the first quarter 2012.

## **INCOME TAXES**

The effective income tax rate was approximately 27% of pre-tax income for the first quarter 2012 and 2011. The provision for income tax for the three-month periods ended March 31, 2012 and 2011 is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At March 31, 2012, the net deferred tax asset was \$5,003,000, down from the balance at December 31, 2011 of \$6,173,000. The main reason for the decrease in deferred tax asset is related to general business credit carryforwards, which fell to \$233,000 at March 31, 2012 from \$831,000 at December 31, 2011. The reduction in deferred tax asset for general business credit carryforwards resulted from estimated utilization of the credits that would occur based on first quarter 2012 activity. The amount of general business credits to be utilized for the first quarter 2012 was calculated based on the estimated excess of the Corporation's regular tax liability over the alternative minimum tax liability.

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 March 31, 2012 is fully realizable; however, if management determines the Corporation will be unable to realize all or part of the net deferred tax asset, the Corporation would adjust the deferred tax asset, which would negatively impact earnings.

Additional information related to income taxes is presented in Note 10 to the unaudited, consolidated financial statements.

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

### **INFLATION**

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in short-term interest rates. Beginning in September 2007, in response to concerns about weakness in the U.S. economy, the Federal Reserve lowered the fed funds target rate numerous times; in December 2008, it established a target range of 0% to 0.25%, which it has maintained through early 2012. 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.

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 50-400 basis points of current rates.

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

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

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

Table XI, which follows this discussion, is based on the results of calculations performed using the simulation model as of February 29, 2012 and October 31, 2011. The table shows that as of February 29, 2012 and October 31, 2011, the changes in net interest income and changes in market value were within the policy limits in all scenarios.

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 three-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 was 0.48% at February 29, 2012 and 0.43% at October 31, 2011, and has not exceeded 5.15% since the embedded caps were acquired. 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.

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

February 29, 2012 Data

(In Thousands)

Period Ending February 28, 2013

| Basis Point | Interest<br>Income | Interest<br>Expense | Net<br>Interest<br>Income<br>(NII) | NII<br>% | NII<br>Change | Risk<br>Limit |
|-------------|--------------------|---------------------|------------------------------------|----------|---------------|---------------|
| +400        | \$64,964           | \$27,953            | \$37,011                           | -16.5    | %             | 25.0 %        |
| +300        | 62,246             | 22,851              | 39,395                             | -11.1    | %             | 20.0 %        |
| +200        | 59,475             | 18,159              | 41,316                             | -6.8     | %             | 15.0 %        |
| +100        | 56,578             | 13,661              | 42,917                             | -3.1     | %             | 10.0 %        |
| 0           | 53,473             | 9,162               | 44,311                             | 0.0      | %             | 0.0 %         |
| -100        | 50,334             | 8,014               | 42,320                             | -4.5     | %             | 10.0 %        |
| -200        | 49,381             | 8,009               | 41,372                             | -6.6     | %             | 15.0 %        |
| -300        | 49,065             | 8,009               | 41,056                             | -7.3     | %             | 20.0 %        |
| -400        | 48,921             | 8,009               | 40,912                             | -7.7     | %             | 25.0 %        |

**Market Value of Portfolio Equity at February 29, 2012**

| Basis Point | Present<br>Value | Present<br>Value<br>% | Present<br>Value<br>% | Present<br>Risk<br>Limit |
|-------------|------------------|-----------------------|-----------------------|--------------------------|
| +400        | \$166,838        | -21.2                 | %                     | 50.0 %                   |
| +300        | 180,683          | -14.6                 | %                     | 45.0 %                   |
| +200        | 193,449          | -8.6                  | %                     | 35.0 %                   |
| +100        | 203,624          | -3.8                  | %                     | 25.0 %                   |
| 0           | 211,640          | 0.0                   | %                     | 0.0 %                    |
| -100        | 206,413          | -2.5                  | %                     | 25.0 %                   |
| -200        | 220,308          | 4.1                   | %                     | 35.0 %                   |
| -300        | 253,399          | 19.7                  | %                     | 45.0 %                   |
| -400        | 294,290          | 39.1                  | %                     | 50.0 %                   |

October 31, 2011 Data

(In Thousands)

Period Ending October 31, 2012

| Basis Point | Interest<br>Income | Interest<br>Expense | Net<br>Interest<br>Income<br>(NII) | NII<br>% | NII<br>Risk<br>Limit |
|-------------|--------------------|---------------------|------------------------------------|----------|----------------------|
| +400        | \$66,369           | \$29,617            | \$36,752                           | -18.0    | % 25.0 %             |
| +300        | 63,690             | 24,535              | 39,155                             | -12.6    | % 20.0 %             |
| +200        | 60,927             | 19,806              | 41,121                             | -8.2     | % 15.0 %             |
| +100        | 58,095             | 15,076              | 43,019                             | -4.0     | % 10.0 %             |
| 0           | 55,164             | 10,346              | 44,818                             | 0.0      | % 0.0 %              |
| -100        | 51,929             | 8,720               | 43,209                             | -3.6     | % 10.0 %             |
| -200        | 50,441             | 8,680               | 41,761                             | -6.8     | % 15.0 %             |
| -300        | 49,961             | 8,680               | 41,281                             | -7.9     | % 20.0 %             |
| -400        | 49,828             | 8,680               | 41,148                             | -8.2     | % 25.0 %             |

**Market Value of Portfolio Equity at October 31, 2011**

| Basis Point | Present<br>Value<br>Equity | Present<br>Value<br>% | Present<br>Value<br>% | Present<br>Value<br>% | Present<br>Value<br>% |
|-------------|----------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| +400        | \$153,307                  | -23.2                 | %                     | 50.0                  | %                     |
| +300        | 165,701                    | -17.0                 | %                     | 45.0                  | %                     |
| +200        | 178,261                    | -10.7                 | %                     | 35.0                  | %                     |
| +100        | 189,315                    | -5.2                  | %                     | 25.0                  | %                     |
| 0           | 199,726                    | 0.0                   | %                     | 0.0                   | %                     |
| -100        | 197,329                    | -1.2                  | %                     | 25.0                  | %                     |
| -200        | 211,794                    | 6.0                   | %                     | 35.0                  | %                     |
| -300        | 238,309                    | 19.3                  | %                     | 45.0                  | %                     |
| -400        | 278,876                    | 39.6                  | %                     | 50.0                  | %                     |

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

The Corporation's equity securities portfolio consists of investments in stocks of banks and bank holding companies. Investments in bank stocks are subject to risk factors that affect the banking industry in general, including credit risk, competition from non-bank entities, interest rate risk and other factors, which could result in a decline in market prices. Also, losses could occur in individual stocks held by the Corporation because of specific circumstances related to each bank. As discussed further in Note 6 of the consolidated financial statements, the Corporation recognized an impairment loss in earnings related to a bank stock of \$67,000 in the first quarter 2012. The Corporation recognized no OTTI losses related to bank stocks in the first quarter 2011.

Equity securities held as of March 31, 2012 and December 31, 2011 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 March 31, 2012.

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

|  | Mar. 31,<br>2012 | Dec. 31,<br>2011 |
|--|------------------|------------------|
| Cost                                     | \$6,151          | \$5,643          |
| Fair Value                               | 8,699            | 7,728            |
| Hypothetical 10% Decline In Market Value | (870 )           | (773 )           |
| Hypothetical 20% Decline In Market Value | (1,740 )         | (1,546 )         |

**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.

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

**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation's Form 10-K filed February 24, 2012.

**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. At its September 22, 2011 meeting, the Corporation's Board of Directors authorized repurchases of outstanding common stock in open market or privately negotiated transactions, up to a total of \$1 million, as an addition to the stock repurchase program previously announced on May 19, 2011. The Board of Directors' authorizations provide that: (1) the treasury stock repurchase programs became effective when publicly announced and shall continue thereafter until suspended or terminated by the Board of Directors, in its sole discretion; and (2) all shares of common stock repurchased pursuant to the programs 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 March 31, 2012, the maximum additional value available for purchases under this program was \$980,694.

In the first quarter 2012, the Corporation made no purchases of its equity securities.

**Item 3. Defaults Upon Senior Securities**

None

**Removed and Reserved**

**Item**

**4.**

**Item**

**5. Other Information**

None

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

**Item 6. Exhibits**

|  |   |
|--|---|
| 2. Plan of acquisition, reorganization, arrangement, liquidation or succession   | Not applicable  |
| 3. (i) Articles of Incorporation   | Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed September 21, 2009   |
| 3. (ii) By-laws  | Incorporated by reference to Exhibit 3.2 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 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:<br>31.1 Certification of Chief Executive Officer<br>31.2 Certification of Chief Financial Officer | Filed herewith<br>Filed herewith  |
| 32. Section 1350 certifications  | Filed herewith  |
| 33. Report on assessment of compliance with servicing criteria for asset-backed securities   | Not applicable  |
| 34. Attestation report on assessment of compliance with servicing criteria for asset-backed securities   | Not applicable  |

|   |                     |
|---|---------------------|
| 35. Service compliance statement  | Not applicable      |
| 99. Additional exhibits:  |                     |
| 99.1 Additional information mailed or made available online to shareholders with proxy statement and Form 10-K on March 8, 2012 | Filed herewith      |
| 100. XBRL-related documents   | Not applicable      |
| 101. Interactive data file  | Furnished herewith* |

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

\* 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.

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**

May 8, 2012 By: /s/ Charles H. Updegraff, Jr.  
Date                      President and Chief Executive Officer

May 8, 2012 By: /s/ Mark A. Hughes  
Date                      Treasurer and Chief Financial Officer