CITIZENS & NORTHERN CORP
Form 10-Q
August 07, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 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 incorporation or organization)	(I.R.S. Employer Identification No.)

90-92 MAIN STREET, WELLSBORO, PA 16901

(Address of principal executive offices) (Zip code)

570-724-3411

(Registrant's telephone number including area code)

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

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically 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 x 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 x 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 x

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) 12,236,327 Shares Outstanding on August 2, 2012

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PART 1. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
CONSOLIDATED BALANCE SHEETS (Unaudited)

(In Thousands Except Share Data)	June 30, 2012	December 31, 2011
ASSETS		
Cash and due from banks:		
Noninterest-bearing	$19,815	$ 17,618
Interest-bearing	49,343	42,957
Total cash and due from banks	69,158	60,575
Available-for-sale securities, at fair value	478,368	481,685
Loans held for sale	3,190	939
Loans receivable	704,434	708,315
Allowance for loan losses	(7,657)	(7,705)
Loans, net	696,777	700,610
Bank-owned life insurance	21,125	20,889
Accrued interest receivable	4,556	4,797
Bank premises and equipment, net	19,090	19,028
Foreclosed assets held for sale	904	1,235
Deferred tax asset, net	3,962	6,173
Intangible asset - Core deposit intangibles	175	212
Intangible asset – Goodwill	11,942	11,942
Other assets	18,280	15,650
TOTAL ASSETS	$1,327,527	$ 1,323,735
LIABILITIES		
Deposits:		
Noninterest-bearing	$199,089	$ 193,595
Interest-bearing	830,367	824,611
Total deposits	1,029,456	1,018,206
Short-term borrowings	4,242	4,950
Long-term borrowings	110,038	125,363
Accrued interest and other liabilities	7,729	7,831
TOTAL LIABILITIES	$1,151,465	1,156,350
STOCKHOLDERS' EQUITY		
Preferred stock, $1,000 par value; authorized 30,000 shares; $1,000 liquidation preference per share; no shares issued at June 30, 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 12,489,836 at June 30, 2012 and 12,460,920 at December 31, 2011	12,490	12,461
Paid-in capital	67,817	67,568
Retained earnings	88,956	82,302
Treasury stock, at cost; 254,519 shares at June 30, 2012 and 305,391 shares at December 31, 2011	(4,255)	(5,106)
Sub-total	165,008	157,225
Accumulated other comprehensive income:		
Unrealized gains on available-for-sale securities	11,519	10,791

Defined benefit plans	(465)	(631)
Total accumulated other comprehensive income	11,054	10,160
TOTAL STOCKHOLDERS' EQUITY	176,062	167,385
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	$1,327,527	$ 1,323,735

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

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CONSOLIDATED STATEMENTS OF OPERATIONS	3 Months Ended		Fiscal Year To Date	
(In Thousands, Except Per Share Data) (Unaudited)	June 30,	June 30,	6 Months Ended June 30,	
	2012	2011	2012	2011
INTEREST INCOME				
Interest and fees on loans	$ 10,265	$ 10,854	$ 20,640	$ 21,722
Interest on balances with depository institutions	31	16	59	32
Interest on loans to political subdivisions	375	372	752	747
Income from available-for-sale and held-to-maturity securities:				
Taxable	2,520	2,849	5,178	5,542
Tax-exempt	1,265	1,291	2,528	2,575
Dividends	73	61	148	123
Total interest and dividend income	14,529	15,443	29,305	30,741
INTEREST EXPENSE				
Interest on deposits	1,271	2,267	2,621	4,835
Interest on short-term borrowings	1	8	4	14
Interest on long-term borrowings	1,129	1,353	2,278	2,795
Total interest expense	2,401	3,628	4,903	7,644
Net interest income	12,128	11,815	24,402	23,097
Provision (credit) for loan losses	367	31	185	(161)
Net interest income after provision (credit) for loan losses	11,761	11,784	24,217	23,258
OTHER INCOME				
Service charges on deposit accounts	1,256	1,225	2,417	2,356
Service charges and fees	235	207	455	425
Trust and financial management revenue	960	946	1,889	1,823
Interchange revenue from debit card transactions	488	485	983	937
Net gains from sale of loans	373	155	638	414
Increase in cash surrender value of life insurance	117	132	236	254
Insurance commissions, fees and premiums	73	58	107	126
Impairment loss on limited partnership investment	0	0	0	(948)
Other operating income	593	465	1,129	841
Sub-total	4,095	3,673	7,854	6,228
Total other-than-temporary impairment losses on available-for-sale securities	0	0	(67)	0
Portion of (gain) loss recognized in other comprehensive loss (before taxes)	0	0	0	0
Net impairment losses recognized in earnings	0	0	(67)	0
Realized gains on available-for-sale securities, net	203	163	268	2,002
Net realized gains on available-for-sale securities	203	163	201	2,002
Total other income	4,298	3,836	8,055	8,230
OTHER EXPENSES				
Salaries and wages	3,586	3,469	7,161	6,870
Pensions and other employee benefits	1,090	1,018	2,456	2,324
Occupancy expense, net	628	665	1,264	1,397
Furniture and equipment expense	461	453	943	937
FDIC Assessments	157	189	303	514
Pennsylvania shares tax	340	320	672	639
Other operating expense	2,018	1,680	3,998	3,376

Total other expenses	8,280	7,794	16,797	16,057
Income before income tax provision	7,779	7,826	15,475	15,431
Income tax provision	2,094	2,129	4,203	4,193
NET INCOME	$5,685	$5,697	$ 11,272	$ 11,238
NET INCOME PER SHARE - BASIC	$0.46	$0.47	$ 0.92	$ 0.92
NET INCOME PER SHARE - DILUTED	$0.46	$0.47	$ 0.92	$ 0.92

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

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands) (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income	$ 5,685	$ 5,697	$ 11,272	$ 11,238
Unrealized gains on available-for-sale securities:				
Unrealized holding gains on available-for-sale securities	1,227	5,949	1,571	12,074
Reclassification adjustment for gains realized in income	(203)	(163)	(201)	(2,002)
Other comprehensive gain on available-for-sale securities	1,024	5,786	1,370	10,072
Unfunded pension and postretirement obligations:				
Change in items from defined benefit plans included in accumulated other comprehensive income	0	(3)	200	(122)
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	20	14	40	27
Other comprehensive gain (loss) on unfunded retirement obligations	20	11	240	(95)
Other comprehensive income before income tax	1,044	5,797	1,610	9,977
Income tax related to other comprehensive income	(364)	(1,969)	(716)	(3,390)
Net other comprehensive income	680	3,828	894	6,587
Total comprehensive income	$ 6,365	$ 9,525	$ 12,166	$ 17,825

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CONSOLIDATED STATEMENTS OF CASH FLOWS	Six Months Ended June 30,	
(In Thousands) (Unaudited)	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 11,272	$ 11,238
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision (credit) for loan losses	185	(161)
Realized gains on available-for-sale securities, net	(201)	(2,002)
Gain on disposition of premises and equipment	(270)	0
Loss on sale of foreclosed assets, net	80	43
Depreciation expense	964	1,058
Accretion and amortization on securities, net	416	753
Accretion and amortization on loans, deposits and borrowings, net	(26)	(18)
Amortization of mortgage servicing rights	44	29
Impairment loss on limited partnership interest	0	948
Increase in cash surrender value of life insurance	(236)	(254)
Stock-based compensation	411	351
Amortization of core deposit intangibles	37	57
Deferred income taxes	1,495	2,562
Gains on sales of mortgage loans, net	(638)	(414)
Origination of mortgage loans for sale	(22,121)	(8,453)
Proceeds from sales of mortgage loans	20,379	13,807
(Increase) decrease in accrued interest receivable and other assets	(2,517)	2,750
(Decrease) increase in accrued interest payable and other liabilities	(308)	507
Net Cash Provided by Operating Activities	8,966	22,801
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of certificates of deposit	(960)	0
Proceeds from sales of available-for-sale securities	11,781	16,615
Proceeds from calls and maturities of available-for-sale securities	56,423	54,054
Purchase of available-for-sale securities	(63,502)	(79,627)
Redemption of Federal Home Loan Bank of Pittsburgh stock	648	796
Net decrease in loans	3,159	14,424
Purchase of premises and equipment	(1,028)	(266)
Proceeds from disposition of premises and equipment	454	0
Purchase of investment in limited liability entity	(534)	(200)
Return of principal on limited liability entity investments	47	70
Proceeds from sale of foreclosed assets	858	230
Net Cash Provided by Investing Activities	7,346	6,096
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	11,244	(8,996)
Net (decrease) increase in short-term borrowings	(708)	1,930
Repayments of long-term borrowings	(15,325)	(15,313)
Purchase of treasury stock	0	(571)
Sale of treasury stock	155	16
Tax benefit from compensation plans	30	31
Common dividends paid	(4,085)	(2,903)
Net Cash Used in Financing Activities	(8,689)	(25,806)
INCREASE IN CASH AND CASH EQUIVALENTS	7,623	3,091
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	56,815	46,301

CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 64,438	$ 49,392
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Assets acquired through foreclosure of real estate loans	$ 521	$ 1,401
Accrued purchase of available-for-sale securities	$ 230	$ 0
Interest paid	$ 5,117	$ 7,694
Income taxes paid	$ 3,050	$ 400

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

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Consolidated Statements of Changes in Stockholders' Equity

Six Months Ended June 30, 2012 and 2011

(In Thousands Except Share and Per Share Data) (Unaudited)	Common Shares	Treasury Shares	Common Stock	Paid-in Capital	Retained Earnings	Accum. Other Comprehensive Income (Loss)	Treasur Stock
Six Months Ended June 30, 2012:							
Balance, December 31, 2011	12,460,920	305,391	$12,461	$67,568	$82,302	$ 10,160	$(5,106
Net income					11,272		
Other comprehensive income, net						894	
Cash dividends declared on common stock, $.38 per share					(4,640)		
Shares issued for dividend reinvestment Plan	28,916		29	526			
Shares issued from treasury related to exercise of stock options		(10,352)		(19)			174
Restricted stock granted		(42,552)		(711)			711
Forfeiture of restricted stock		2,032		34			(34
Stock-based compensation expense				411			
Tax benefit of stock options				8			
Tax benefit from employee benefit plan					22		
Balance, June 30, 2012	12,489,836	254,519	$12,490	$67,817	$88,956	$ 11,054	$(4,255
Six Months Ended June 30, 2011:							
Balance, December 31, 2010	12,408,212	254,614	$12,408	$66,648	$65,920	($1,601)	$(4,431
Net income					11,238		
Other comprehensive income, net						6,587	
Cash dividends declared on common stock, $.27 per share					(3,287)		
Shares issued for dividend reinvestment plan	24,556		25	359			
Treasury stock purchased		40,302					(571
Shares issued from treasury related to exercise of stock options		(1,108)		(3)			19
Restricted stock granted		(15,622)		(272)			272
Forfeiture of restricted stock		189		3			(3
Stock-based compensation expense				351			
Tax benefit from employee benefit plan					31		
Balance, June 30, 2011	12,432,768	278,375	$12,433	$67,086	$73,902	$ 4,986	$(4,714

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

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 and six-month periods ended June 30, 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	Weighted-Average Common Shares	Earnings Per Share
Six Months Ended June 30, 2012			
Earnings per share – basic	$11,272,000	12,216,339	$ 0.92
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		204,836	
Hypothetical share repurchase at $19.35		(177,872)	
Earnings per share – diluted	$11,272,000	12,243,303	$ 0.92

Six Months Ended June 30, 2011			
Earnings per share – basic	$11,238,000	12,176,027	$ 0.92
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		93,266	
Hypothetical share repurchase at $15.58		(90,140)	
Earnings per share – diluted	$11,238,000	12,179,153	$ 0.92
Quarter Ended June 30, 2012			
Earnings per share – basic	$5,685,000	12,225,808	$ 0.46
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		137,591	
Hypothetical share repurchase at $18.26		(120,566)	
Earnings per share – diluted	$5,685,000	12,242,833	$ 0.46

	Net Income	Weighted-Average Common Shares	Earnings Per Share
Quarter Ended June 30, 2011			
Earnings per share – basic	$5,697,000	12,177,110	$ 0.47
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		92,449	
Hypothetical share repurchase at $15.58		(89,360)	
Earnings per share – diluted	$5,697,000	12,180,199	$ 0.47

Stock options that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 147,509 shares in the six-month period ended June 30, 2012, 225,245 shares in the six-month period ended June 30, 2011, 210,875 shares in the second quarter 2012 and 224,063 shares in the second quarter 2011.

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 Amount	Income Tax Effect	Net-of-Tax Amount
Six Months Ended June 30, 2012			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	$ 1,571	$ (712)	$ 859
Reclassification adjustment for gains realized in income	(201)	70	(131)
Other comprehensive gain on available-for-sale securities	1,370	(642)	728
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	40	(13)	27
Other comprehensive gain on unfunded retirement obligations	240	(74)	166
Total other comprehensive income	$ 1,610	$ (716)	$ 894

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	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Six Months Ended June 30, 2011			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	$ 12,074	$ (4,103)	$ 7,971
Reclassification adjustment for gains realized in income	(2,002)	681	(1,321)
Other comprehensive gain on available-for-sale securities	10,072	(3,422)	6,650
Unfunded pension and postretirement obligations:			
Change in items from defined benefit plans included in accumulated other comprehensive income	(122)	41	(81)
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	27	(9)	18
Other comprehensive loss on unfunded retirement obligations	(95)	32	(63)
Total other comprehensive income	$ 9,977	$ (3,390)	$ 6,587

	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Quarter Ended June 30, 2012			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	$ 1,227	$ (428)	$ 799
Reclassification adjustment for gains realized in income	(203)	71	(132)
Other comprehensive gain on available-for-sale securities	1,024	(357)	667
Unfunded pension and postretirement obligations:			
Change in items from defined benefit plans included in accumulated other comprehensive income	0	0	0
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	20	(7)	13
Other comprehensive gain on unfunded retirement obligations	20	(7)	13
Total other comprehensive income	$ 1,044	$ (364)	$ 680

	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Quarter Ended June 30, 2011			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	$ 5,949	$ (2,021)	$ 3,928
Reclassification adjustment for gains realized in income	(163)	56	(107)
Other comprehensive gain on available-for-sale securities	5,786	(1,965)	3,821
Unfunded pension and postretirement obligations:			

Change in items from defined benefit plans included in accumulated other comprehensive income	(3)	1	(2)
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	14	(5)	9
Other comprehensive gain on unfunded retirement obligations	11	(4)	7
Total other comprehensive income	$ 5,797	$ (1,969)	$ 3,828

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

	Unrealized Holding Gains on Securities	Unfunded Retirement Obligations	Accumulated Other Comprehensive Income
Six Months Ended June 30, 2012			
Balance, beginning of period	$ 10,791	$ (631)	$ 10,160
Change during six months ended June 30, 2012	728	166	894
Balance, end of period	$ 11,519	$ (465)	$ 11,054
Six Months Ended June 30, 2011			
Balance, beginning of period	$ (1,351)	$ (250)	$ (1,601)
Change during six months ended June 30, 2011	6,650	(63)	6,587
Balance, end of period	$ 5,299	$ (313)	$ 4,986
Quarter Ended June 30, 2012			
Balance, beginning of period	$ 10,852	$ (478)	$ 10,374
Change during three months ended June 30, 2012	667	13	680
Balance, end of period	$ 11,519	$ (465)	$ 11,054
Quarter Ended June 30, 2011			
Balance, beginning of period	$ 1,478	$ (320)	$ 1,158
Change during three months ended June 30, 2011	3,821	7	3,828
Balance, end of period	$ 5,299	$ (313)	$ 4,986

4. CASH AND DUE FROM BANKS

Cash and due from banks at June 30, 2012 and December 31, 2011 include the following:

(In thousands)	June 30, 2012	Dec. 31, 2011
Cash and cash equivalents	$64,438	$56,815
Certificates of deposit	4,720	3,760
Total cash and due from banks	$69,158	$60,575

Certificates of deposit are issues 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 $13,739,000 at June 30, 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.

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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.

At June 30, 2012 and December 31, 2011, assets measured at fair value and the valuation methods used are as follows:

		June 30, 2012		
(In Thousands)	Quoted Prices in Active Markets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total Fair Value
Recurring fair value measurements				
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of U.S. Government agencies	$ 0	$23,916	$ 0	$23,916
Obligations of states and political subdivisions:				
Tax-exempt	0	141,140	0	141,140
Taxable	0	19,924	0	19,924
Mortgage-backed securities	0	108,426	0	108,426
Collateralized mortgage obligations, Issued by U.S. Government agencies	0	165,923	0	165,923
Trust preferred securities issued by individual institutions	0	6,221	0	6,221
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	0	0	2,386	2,386
Pooled trust preferred securities - mezzanine tranches	0	0	1,146	1,146
Other collateralized debt obligations	0	660	0	660
Total debt securities	0	466,210	3,532	469,742
Marketable equity securities	8,626	0	0	8,626
Total available-for-sale securities	8,626	466,210	3,532	478,368

Servicing rights	0	0	460	460
Total recurring fair value measurements	$ 8,626	$466,210	$ 3,992	$478,828
Nonrecurring fair value measurements				
Impaired loans with a valuation allowance	$ 0	$0	$ 3,434	$3,434
Valuation allowance	0	0	(1,303)	(1,303)
Impaired loans, net	0	0	2,131	2,131
Foreclosed assets held for sale	0	0	904	904
Total nonrecurring fair value measurements	$ 0	$0	$ 3,035	$3,035

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	December 31, 2011			
(In Thousands)	Quoted Prices in Active Markets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total Fair Value
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 June 30, 2012 for assets measured using unobservable inputs (Level 3 methodologies) on a recurring basis:

Asset	Fair Value at 6/30/12 (In Thousands)	Valuation Technique	Unobservable Input(s)			M 6/
Pooled trust preferred securities - senior tranches	$2,386	Discounted cash flow	Issuer defaults	46.15	%	A
				23.31	%	E
			Issuer prepayments	34.99	%	E
			Discount rate	11.70	%	In
Pooled trust preferred securities - mezzanine tranches	1,146	Discounted cash flow	Issuer defaults	22.95	%	A
				33.92	%	E
			Future interest rates			T
			Issuer prepayments	3.70	%	E
			Discount rate	3.95	%	C
Servicing rights	460	Discounted cash flow	Discount rate	12.00	%	R
			Loan prepayment speeds	292.00	%	W
			Servicing fees	0.25	%	o
				5.00	%	o
				5.00	%	la
				$1.94		M
			Servicing costs	$5.50		M
				$22.00		A
				1.00	%	o
				3.00	%	a

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 June 30, 2012				Six Months Ended June 30, 2012			
	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Servicing Rights	Total	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Servicing Rights	Total
Balance, beginning of period	$4,638	$ 782	$ 409	$5,829	$4,638	$ 730	$ 375	$5,743
Issuances of servicing rights	0	0	74	74	0	0	129	129
Accretion and amortization, net	(2)	0	0	(2)	(5)	0	0	(5)
Proceeds from sales and calls	(2,515)	(27)	0	(2,542)	(2,515)	(54)	0	(2,569)
Realized gains, net	40	27	0	67	40	54	0	94
Unrealized losses included in earnings	0	0	(23)	(23)	0	0	(44)	(44)
Unrealized gains included in other comprehensive income	225	364	0	589	228	416	0	644
Balance, end of period	$2,386	$ 1,146	$ 460	$3,992	$2,386	$ 1,146	$ 460	$3,992

	Three Months Ended June 30, 2011				Six Months Ended June 30, 2011			
	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Servicing Rights	Total	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Servicing Rights	Total
Balance, beginning of period	$9,038	$ 0	$ 293	$9,331	$7,400	$ 0	$ 204	$7,604
Issuances of servicing rights	0	0	38	38	0	0	140	140
Accretion and amortization, net	(14)	0	0	(14)	(34)	0	0	(34)
Proceeds from sales and calls	(2,035)	(25)	0	(2,060)	(2,035)	(50)	0	(2,085)
Realized gains, net	25	25	0	50	25	50	0	75
Unrealized losses included in earnings	0	0	(16)	(16)	0	0	(29)	(29)
Unrealized gains included in other comprehensive income	193	0	0	193	1,851	0	0	1,851
Balance, end of period	$7,207	$ 0	$ 315	$7,522	$7,207	$ 0	$ 315	$7,522

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 June 30, 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	June 30, 2012		**December 31, 2011**	
	Method(s)	Carrying	Fair	Carrying	Fair

	Used	Amount	Value	Amount	Value
Financial assets:					
Cash and cash equivalents	Level 1	$64,438	$64,438	$56,815	$56,815
Certificates of deposit	Level 2	4,720	4,738	3,760	3,683
Available-for-sale securities	See Above	478,368	478,368	481,685	481,685
Restricted equity securities (included in Other Assets)	Level 2	6,125	6,125	6,773	6,773
Loans held for sale	Level 1	3,190	3,190	939	939
Loans, net	Level 3	696,777	716,462	700,610	718,274
Accrued interest receivable	Level 1	4,556	4,556	4,797	4,797
Servicing rights	Level 3	460	460	375	375
Financial liabilities:					
Deposits with no stated maturity	Level 1	683,183	683,183	677,461	677,461
Time deposits	Level 3	346,273	349,561	340,745	344,936
Short-term borrowings	Level 3	4,242	4,208	4,950	4,897
Long-term borrowings	Level 3	110,038	125,159	125,363	145,641
Accrued interest payable	Level 1	210	210	358	358

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6. SECURITIES

Amortized cost and fair value of available-for-sale securities at June 30, 2012 and December 31, 2011 are summarized as follows:

	June 30, 2012			
(In Thousands)	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Obligations of U.S. Government agencies	$ 23,244	$ 672	$ 0	$ 23,916
Obligations of states and political subdivisions:				
Tax-exempt	135,736	5,894	(490)	141,140
Taxable	19,524	437	(37)	19,924
Mortgage-backed securities	103,801	4,625	0	108,426
Collateralized mortgage obligations, Issued by U.S. Government agencies	162,780	3,153	(10)	165,923
Trust preferred securities issued by individual institutions	6,179	42	0	6,221
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	2,516	0	(130)	2,386
Pooled trust preferred securities - mezzanine tranches	0	1,146	0	1,146
Other collateralized debt obligations	660	0	0	660
Total debt securities	454,440	15,969	(667)	469,742
Marketable equity securities	6,208	2,468	(50)	8,626
Total	$ 460,648	$ 18,437	$ (717)	$ 478,368

	December 31, 2011			
(In Thousands)	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
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
Collateralized mortgage obligations, Issued by U.S. Government agencies	161,818	3,350	(37)	165,131
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 June 30, 2012 and December 31, 2011:

June 30, 2012 (In Thousands)	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
Obligations of states and political subdivisions:						
Tax-exempt	$ 16,333	$ (246)	$ 8,081	$ (244)	$ 24,414	$ (490)
Taxable	3,907	(37)	0	0	3,907	(37)
Collateralized mortgage obligations, Issued by U.S. Government agencies	7,094	(10)	0	0	7,094	(10)
Collateralized debt obligations, Pooled trust preferred securities - senior tranches	0	0	2,386	(130)	2,386	(130)
Total debt securities	27,334	(293)	10,467	(374)	37,801	(667)
Marketable equity securities	412	(49)	89	(1)	501	(50)
Total temporarily impaired available-for-sale securities	$ 27,746	$ (342)	$ 10,556	$ (375)	$ 38,302	$ (717)

December 31, 2011 (In Thousands)	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized 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 U.S. Government agencies	6,886	(36)	5,075	(1)	11,961	(37)
Trust preferred securities issued by individual institutions	0	0	947	(53)	947	(53)
Collateralized debt obligations, Pooled trust 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 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	6 Months Ended

	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Gross realized gains	$ 252	$ 169	$ 317	$ 2,009
Gross realized losses	(49)	(6)	(116)	(7)
Net realized gains	$ 203	$ 163	$ 201	$ 2,002
Income tax provision related to net realized gains	$ 71	$ 56	$ 70	$ 681

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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 June 30, 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 Cost	Fair Value
Due in one year or less	$ 8,791	$ 8,847
Due from one year through five years	51,216	52,756
Due from five years through ten years	35,688	36,350
Due after ten years	92,164	97,440
Subtotal	187,859	195,393
Mortgage-backed securities	103,801	108,426
Collateralized mortgage obligations,		
Issued by U.S. Government agencies	162,780	165,923
Total	$ 454,440	$ 469,742

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 no impairment losses in earnings in the three-month period ended June 30, 2012. The Corporation recognized an impairment loss in earnings totaling $67,000 in the six-month period ended June 30, 2012, which was related to a bank stock. No impairment losses were recognized in the three-month or six-month periods ended June 30, 2011.

A summary of information management considered in evaluating debt and equity securities for OTTI at June 30, 2012 is provided below.

Debt Securities

At June 30, 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 June 30, 2012 to be temporary.

The credit rating agencies have withdrawn their ratings on numerous municipal bonds held by the Corporation. At June 30, 2012, the total amortized cost basis of municipal bonds with no external credit ratings was $22,977,000, with an aggregate unrealized gain 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 June 30, 2012:

(In Thousands)							Moody's/ S&P/ Fitch
		Par Amount	Amortized	Fair	Unrealized	Cumulative Realized Credit	Credit
Name of Issuer	Issuer's Parent Company	Outstanding	Cost	Value	Gain	Losses	Ratings
Astoria Capital Trust I	Astoria Financial Corporation	$ 5,000	$ 5,179	$5,195	$ 16	$ 0	Ba1/BB/B+
Patriot Capital Trust I	Susquehanna Bancshares, Inc.	1,000	1,000	1,026	26	0	NR
Total		$ 6,000	$ 6,179	$6,221	$ 42	$ 0	

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 its holding of a trust preferred security issued by Carolina First Mortgage Loan Trust, a subsidiary of The South Financial Group, Inc. In the fourth quarter 2010, The Toronto-Dominion Bank acquired The South Financial Group, Inc. 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 (included in interest income) totaling $398,000 in the three-month period ended June 30, 2012 and $855,000 in the six-month period ended June 30, 2012. The Corporation recorded accretion income totaling $160,000 in the three-month period ended June 30, 2011 and $271,000 in the six-month period ended June 30, 2011. For the year ended December 31, 2011, the Corporation recorded accretion income totaling $825,000. The security had a face amount of $2,000,000 and matured in 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 June 30, 2012:

(In Thousands)

Security	Tranche	Par Amount Outstanding	Amortized Cost	Fair Value	Unrealized Gain	Cumulative 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	458	458	(1,992)
U.S. Capital Funding II, Ltd.	B-2	3,000	0	688	688	(2,973)
Total		$ 8,000	$ 0	$1,146	$ 1,146	($ 7,953)

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As of June 30, 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 $2,516,000, has been subjected to impairment analysis based on estimated cash flows (using the process described above), and management has determined that impairment was temporary as of June 30, 2012.

The table that follows provides additional information related to pooled trust preferred securities as of June 30, 2012:

Security	MMCAPS Funding I, Ltd.		U.S. Capital Funding II, Ltd.		U.S. Capital Funding II, Ltd.	
Tranche	Senior		B-1		B-2	
Number of Issuers Currently Performing	9		35		35	
Moody's/Fitch Credit Ratings	A3/BBB (1)		Caa3/C		Caa3/C	
Actual Deferrals and Defaults as % of Outstanding Collateral	46.15	%	22.95	%	22.95	%
Expected Additional Net Deferrals and Defaults as % of Performing Collateral	23.31	%	33.92	%	33.92	%
Excess Subordination as % of Performing Collateral	57.60	%	-16.08	%	-16.08	%
Expected Issuer Prepayments as % of Performing Collateral	34.99	%	3.70	%	3.70	%

(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 and six-month periods ended June 30, 2012 and 2011.

Equity Securities

The Corporation's marketable equity securities at June 30, 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 second quarter 2012. The Corporation recognized no OTTI losses related to bank stocks in the first six months of 2011. At June 30, 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 June 30, 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 six months of 2012. In the three-month period ended June 30, 2011, the Corporation realized a gain of $89,000 from the sale of a bank stock for which OTTI had been previously recognized. Realized gains from sales of bank stocks totaled $91,000 in the six-month period ended June 30, 2011 including $89,000 of realized gains from sales of stocks for which OTTI had been previously recognized.

C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 12 regional Federal Home Loan Banks. As a member, C&N Bank is required to purchase and maintain stock in FHLB-Pittsburgh. There is no active market for FHLB-Pittsburgh stock, and it must ordinarily be redeemed by FHLB-Pittsburgh in order to be liquidated. C&N Bank's investment in FHLB-Pittsburgh stock, included in Other Assets in the consolidated balance sheet, was $5,995,000 at June 30, 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 June 30, 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 June 30, 2012 and December 31, 2011 are summarized as follows:

Summary of Loans by Type

(In Thousands)	June 30, 2012	% of Total		Dec. 31, 2011	% of Total	
Residential mortgage:						
Residential mortgage loans - first liens	$321,163	45.59	%	$331,015	46.73	%
Residential mortgage loans - junior liens	27,404	3.89	%	28,851	4.07	%
Home equity lines of credit	31,858	4.52	%	30,037	4.24	%
1-4 Family residential construction	10,699	1.52	%	9,959	1.41	%
Total residential mortgage	391,124	55.52	%	399,862	56.45	%
Commercial:						
Commercial loans secured by real estate	164,771	23.39	%	156,388	22.08	%
Commercial and industrial	52,704	7.48	%	57,191	8.07	%
Political subdivisions	36,858	5.23	%	37,620	5.31	%
Commercial construction	26,517	3.76	%	23,518	3.32	%
Loans secured by farmland	10,079	1.43	%	10,949	1.55	%
Multi-family (5 or more) residential	6,409	0.91	%	6,583	0.93	%
Agricultural loans	3,263	0.46	%	2,987	0.42	%
Other commercial loans	563	0.08	%	552	0.08	%

Total commercial	301,164	42.75 %	295,788	41.76 %
Consumer	12,146	1.72 %	12,665	1.79 %
Total	704,434	100.00 %	708,315	100.00 %
Less: allowance for loan losses	(7,657)		(7,705)	
Loans, net	$696,777		$700,610	

The Corporation grants loans to individuals as well as commercial and tax-exempt entities. Commercial, residential and personal loans are made to customers geographically concentrated in the Pennsylvania and New York counties that comprise the market serviced by Citizens & Northern Bank. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. There is no concentration of loans to borrowers engaged in similar businesses or activities that exceed 10% of total loans at either June 30, 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 June 30, 2012 and December 31, 2011, management determined that no allowance for credit losses related to unfunded loan commitments was required.

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Transactions within the allowance for loan losses, summarized by segment and class, for the three-month and six-month periods ended June 30, 2012 and 2011 were as follows:

Six Months Ended June 30, 2012 (In Thousands)	Dec. 31, 2011 Balance	Charge-offs	Recoveries	Provision (Credit)	June 30, 2012 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	$ 3,026	$ (188)	$ 18	$ 32	$ 2,888
Residential mortgage loans - junior liens	266			(12)	254
Home equity lines of credit	231			14	245
1-4 Family residential construction	79			1	80
Total residential mortgage	3,602	(188)	18	35	3,467
Commercial:					
Commercial loans secured by real estate	2,004			(28)	1,976
Commercial and industrial	946	(35)	5	(204)	712
Political subdivisions	0			0	0
Commercial construction	267			339	606
Loans secured by farmland	126			(9)	117
Multi-family (5 or more) residential	66			(2)	64
Agricultural loans	27			2	29
Other commercial loans	5			0	5
Total commercial	3,441	(35)	5	98	3,509
Consumer	228	(68)	35	50	245
Unallocated	434			2	436
Total Allowance for Loan Losses	$ 7,705	$ (291)	$ 58	$ 185	$ 7,657

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Six Months Ended June 30, 2011

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

Three Months Ended June 30, 2012

(In Thousands)	March 31, 2012 Balance	Charge-offs	Recoveries	Provision (Credit)	June 30, 2012 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	$ 2,953	$ (50)	$ 18	$ (33)	$ 2,888
Residential mortgage loans - junior liens	260			(6)	254
Home equity lines of credit	232			13	245
1-4 Family residential construction	62			18	80
Total residential mortgage	3,507	(50)	18	(8)	3,467
Commercial:					
Commercial loans secured by real estate	1,920			56	1,976
Commercial and industrial	762	(35)	4	(19)	712
Political subdivisions	0			0	0

Commercial construction and land	325			281	606
Loans secured by farmland	121			(4)	117
Multi-family (5 or more) residential	63			1	64
Agricultural loans	27			2	29
Other commercial loans	3			2	5
Total commercial	3,221	(35)	4	319	3,509
Consumer	206	(30)	13	56	245
Unallocated	436			0	436
Total Allowance for Loan Losses	$ 7,370	$ (115)	$ 35	$ 367	$ 7,657

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Three Months Ended June 30, 2011

(In Thousands)	March 31, 2011 Balance	Charge-offs	Recoveries	Provision (Credit)	June 30, 2011 Balance
Allowance for Loan Losses:					
Residential mortgage:					
Residential mortgage loans - first liens	$ 3,150	$ (27)	$ 0	$ (73)	$ 3,050
Residential mortgage loans - junior liens	305	0	0	(12)	293
Home equity lines of credit	212	0	0	8	220
1-4 Family residential construction	62	0	0	5	67
Total residential mortgage	3,729	(27)	0	(72)	3,630
Commercial:					
Commercial loans secured by real estate	3,118	(535)	0	(81)	2,502
Commercial and industrial	842	(199)	176	89	908
Political subdivisions	0	0	0	0	0
Commercial construction	271	0	0	10	281
Loans secured by farmland	142	0	0	(8)	134
Multi-family (5 or more) residential	77	0	0	(2)	75
Agricultural loans	29	0	0	0	29
Other commercial loans	8	0	0	(3)	5
Total commercial	4,487	(734)	176	5	3,934
Consumer	275	(39)	16	23	275
Unallocated	355			75	430
Total Allowance for Loan Losses	$ 8,846	$ (800)	$ 192	$ 31	$ 8,269

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 June 30, 2012 and December 31, 2011:

June 30, 2012: (In Thousands)	Pass	Special Mention	Substandard	Doubtful	Total
Residential mortgage:					
Residential mortgage loans - first liens	$306,272	$ 2,216	$ 12,476	$ 199	$321,163
Residential mortgage loans - junior liens	25,978	536	890	0	27,404
Home equity lines of credit	31,231	361	266	0	31,858
1-4 Family residential construction	10,616	0	83	0	10,699
Total residential mortgage	374,097	3,113	13,715	199	391,124
Commercial:					
Commercial loans secured by real estate	152,208	7,462	5,101	0	164,771
Commercial and industrial	44,154	4,174	4,163	213	52,704
Political subdivisions	36,742	116	0	0	36,858
Commercial construction and land	24,697	221	1,599	0	26,517
Loans secured by farmland	7,758	763	1,523	35	10,079
Multi-family (5 or more) residential	6,044	354	11	0	6,409
Agricultural loans	3,171	29	63	0	3,263
Other commercial loans	563	0	0	0	563
Total commercial	275,337	13,119	12,460	248	301,164
Consumer	11,956	17	173	0	12,146
Totals	$661,390	$ 16,249	$ 26,348	$ 447	$704,434

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December 31, 2011:

(In Thousands)	Pass	Special Mention	Substandard	Doubtful	Total
Residential mortgage:					
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
Commercial:					
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
Totals	$660,045	$19,744	$ 27,153	$ 1,373	$708,315

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

The qualitative factors used in the general component calculations are designed to address credit risk characteristics associated with each segment. The Corporation's credit risk associated with all of the segments is significantly impacted by these factors, which include economic conditions within its market area, the Corporation's lending policies, changes or trends in the portfolio, risk profile, competition, regulatory requirements and other factors. Further, the residential mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation's commercial segment loans (approximately 69% at June 30, 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 June 30, 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 June 30, 2012 and December 31, 2011:

June 30, 2012 (In Thousands)	Loans: Individually Evaluated	 Collectively Evaluated	 Totals	Allowance for Loan Losses: Individually Evaluated	 Collectively Evaluated	 Totals
Residential mortgage:						
Residential mortgage loans - first liens	$1,716	$ 319,447	$321,163	$396	$ 2,492	$2,888
Residential mortgage loans - junior liens	58	27,346	27,404	0	254	254
Home equity lines of credit	0	31,858	31,858	0	245	245
1-4 Family residential construction	0	10,699	10,699	0	80	80
Total residential mortgage	1,774	389,350	391,124	396	3,071	3,467
Commercial:						
Commercial loans secured by real estate	1,805	162,966	164,771	150	1,826	1,976
Commercial and industrial	782	51,922	52,704	297	415	712
Political subdivisions	0	36,858	36,858	0	0	0
Commercial construction	1,476	25,041	26,517	381	225	606
Loans secured by farmland	925	9,154	10,079	35	82	117
Multi-family (5 or more) residential	11	6,398	6,409	0	64	64
Agricultural loans	40	3,223	3,263	0	29	29
Other commercial loans	0	563	563	0	5	5
Total commercial	5,039	296,125	301,164	863	2,646	3,509
Consumer	48	12,098	12,146	44	201	245
Unallocated						436
Total	$6,861	$ 697,573	$704,434	$1,303	$ 5,918	$7,657

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December 31, 2011 (In Thousands)	Loans: Individually Evaluated	Collectively Evaluated	Totals	Allowance for Loan Losses: Individually Evaluated	Collectively Evaluated	Totals
Residential mortgage:						
Residential mortgage loans - first liens	$2,227	$ 328,788	$331,015	$461	$ 2,565	$3,026
Residential mortgage loans - junior liens	137	28,714	28,851	11	255	266
Home equity lines of credit	93	29,944	30,037	0	231	231
1-4 Family residential construction	0	9,959	9,959	0	79	79
Total residential mortgage	2,457	397,405	399,862	472	3,130	3,602
Commercial:						
Commercial loans secured by real estate	2,169	154,219	156,388	169	1,835	2,004
Commercial and industrial	942	56,249	57,191	361	585	946
Political subdivisions	0	37,620	37,620	0	0	0
Commercial construction	1,266	22,252	23,518	65	202	267
Loans secured by farmland	927	10,022	10,949	35	91	126
Multi-family (5 or more) residential	14	6,569	6,583	0	66	66
Agricultural loans	39	2,948	2,987	0	27	27
Other commercial loans	0	552	552	0	5	5
Total commercial	5,357	290,431	295,788	630	2,811	3,441
Consumer	50	12,615	12,665	24	204	228
Unallocated						434
Total	$7,864	$ 700,451	$708,315	$1,126	$ 6,145	$7,705

Summary information related to impaired loans as of June 30, 2012 and December 31, 2011 is as follows:

(In Thousands)	As of June 30, 2012	As of Dec. 31, 2011
Impaired loans with a valuation allowance	$3,434	$3,433
Impaired loans without a valuation allowance	3,427	4,431
Total impaired loans	$6,861	$7,864
Valuation allowance related to impaired loans	$1,303	$1,126

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

(In Thousands)	3 Months Ended June 30, 2012	2011	6 Months Ended June 30, 2012	2011
Average investment in impaired loans	$6,930	$7,266	$7,025	$8,020
Interest income recognized on impaired loans	55	36	138	86
Interest income recognized on a cash basis on impaired loans	55	36	138	86

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

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

(In Thousands)	June 30, 2012		December 31, 2011	
	Past Due 90+ Days and Accruing	Nonaccrual	Past Due 90+ Days and Accruing	Nonaccrual
Residential mortgage:				
Residential mortgage loans - first liens	$931	$ 3,261	$ 949	$ 3,058
Residential mortgage loans - junior liens	71	65	11	67
Total residential mortgage	1,002	3,326	960	3,125
Commercial:				
Commercial loans secured by real estate	105	1,342	75	1,595
Commercial and industrial	30	456	21	541
Commercial construction	0	1,328	139	978
Loans secured by farmland	0	925	53	927
Agricultural loans	0	40	0	0
Total commercial	135	4,091	288	4,041
Consumer	7	30	19	31
Totals	$1,144	$ 7,447	$ 1,267	$ 7,197

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 June 30, 2012 and December 31, 2011:

(In Thousands)	As of June 30, 2012				As of December 31, 2011			
	Current & Past Due Less than 30 Days	Past Due 30-89 Days	Past Due 90+ Days	Total	Current & Past Due Less than 30 Days	Past Due 30-89 Days	Past Due 90+ Days	Total
Residential mortgage:								
Residential mortgage loans - first liens	$314,401	$4,831	$1,931	$321,163	$321,907	$6,723	$2,385	$331,015
	27,212	111	81	27,404	28,437	393	21	28,851

Residential mortgage loans - junior liens								
Home equity lines of credit	31,621	237	0	31,858	29,986	51	0	30,037
1-4 Family residential construction	10,699	0	0	10,699	9,959	0	0	9,959
Total residential mortgage	383,933	5,179	2,012	391,124	390,289	7,167	2,406	399,862
Commercial:								
Commercial loans secured by real estate	163,391	545	835	164,771	155,025	343	1,020	156,388
Commercial and industrial	52,313	277	114	52,704	56,835	169	187	57,191
Political subdivisions	36,858	0	0	36,858	37,620	0	0	37,620
Commercial construction	25,191	387	939	26,517	22,323	1,056	139	23,518
Loans secured by farmland	9,122	67	890	10,079	9,973	33	943	10,949
Multi-family (5 or more) residential	6,406	3	0	6,409	6,583	0	0	6,583
Agricultural loans	3,223	0	40	3,263	2,945	3	39	2,987
Other commercial loans	557	6	0	563	552	0	0	552
Total commercial	297,061	1,285	2,818	301,164	291,856	1,604	2,328	295,788
Consumer	11,956	183	7	12,146	12,340	306	19	12,665
Totals	$692,950	$6,647	$4,837	$704,434	$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 June 30, 2012 and December 31, 2011 is as follows:

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(In Thousands)	Current & Past Due Less than 30 Days	Past Due 30-89 Days	Past Due 90+ Days	Total
June 30, 2012 Nonaccrual Totals	$2,298	$1,456	$3,693	$7,447
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.

The outstanding balance of loans subject to TDRs, as well as contractual aging information at June 30, 2012 and December 31, 2011 is as follows:

Troubled Debt Restructurings (TDRs)

(In Thousands)	Current & Past Due Less than 30 Days	Past Due 30-89 Days	Past Due 90+ Days	Nonaccrual	Total
June 30, 2012 Totals	$925	$ 0	$0	$ 1,754	$2,679
December 31, 2011 Totals	$1,064	$ 0	$146	$ 2,267	$3,477

There were no TDRs that occurred during the second quarter 2012. TDRs that occurred during the six-month period ended June 30, 2012 are as follows:

Six Months Ended June 30, 2012 (Balances in Thousands)	Pre-Modification	Post-Modification

	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
Commercial, Commercial and industrial	1	$ 65	$ 65

The TDR in the six-month period ended June 30, 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 June 30, 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 six months of 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 June 30, 2012. The outstanding balance of the loans was $466,000 at June 30, 2012. The loans were in nonaccrual status at June 30, 2012 and December 31, 2011. At June 30, 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 June 30, 2012 and December 31, 2011.

In the second quarter 2012, there were no defaults on loans for which modifications considered to be TDRs were entered into within the previous 12 months. In the six-month period ended June 30, 2012, such defaults are as follows:

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Six Months Ended June 30, 2012

(Balances in Thousands)	Number of Contracts	Recorded Investment
Commercial, 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 $274,000 at June 30, 2012, an increase of $209,000 over the allowance on the loan at December 31, 2011.

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 June 30, 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 (In Thousands)	Pension Six Months Ended June 30,		Postretirement Six Months Ended June 30,	
	2012	2011	2012	2011
Service cost	$ 0	$ 0	$ 46	$ 42
Interest cost	36	37	41	46
Expected return on plan assets	(36)	(36)	0	0
Amortization of transition (asset) obligation	0	0	18	18

Amortization of prior service cost	0	0	7	7
Recognized net actuarial loss	15	2	0	0
Net periodic benefit cost	$ 15	$ 3	$ 112	$ 113

Defined Benefit Plans (In Thousands)	Pension		Postretirement	
	Three Months Ended June 30,		Three Months Ended June 30,	
	2012	2011	2012	2011
Service cost	$ 0	$ 0	$ 23	$ 21
Interest cost	18	19	21	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	3	4
Recognized net actuarial loss	8	1	0	0
Net periodic benefit cost	$ 8	$ 2	$ 56	$ 57

In the first six months of 2012, the Corporation funded postretirement contributions totaling $29,000, 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 required in 2012, though the Corporation may make additional discretionary contributions.

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 will 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 %

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 six 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)	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Stock options	$88	$123	$247	$279
Restricted stock	82	36	164	72
Total	$170	$159	$411	$351

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10. INCOME TAXES

The net deferred tax asset at June 30, 2012 and December 31, 2011 represents the following temporary difference components:

(In Thousands)	June 30, 2012	December 31, 2011
Deferred tax assets:		
Defined benefit plans - ASC 835	$250	$ 324
Net realized losses on securities	2,915	3,175
Allowance for loan losses	2,680	2,697
Credit for alternative minimum tax paid	4,070	4,569
Net operating loss carryforwards	44	44
General business credit carryforwards	0	831
Other deferred tax assets	1,786	1,671
Total deferred tax assets	11,745	13,311
Deferred tax liabilities:		
Unrealized holding gains on securities	6,201	5,559
Bank premises and equipment	1,386	1,357
Core deposit intangibles	61	74
Other deferred tax liabilities	135	148
Total deferred tax liabilities	7,783	7,138
Deferred tax asset, net	$3,962	$ 6,173

The deferred tax asset from realized losses on securities resulted primarily from OTTI charges for financial statement purposes that are not deductible for income tax reporting purposes through June 30, 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 June 30, 2012, expiring in 2015.

The provision for income tax for the three-month and six-month periods ended June 30, 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 June 30,		Fiscal Year To Date Six Months Ended June 30,	
	2012 (Current)	2011 (Prior Year)	2012 (Current)	2011 (Prior Year)
Income before income tax provision	$ 7,779	$ 7,826	$ 15,475	$ 15,431
Income tax provision	2,094	2,129	4,203	4,193
Effective tax rate	26.92 %	27.20 %	27.16 %	27.17 %

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

The Corporation has 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.

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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 $1,029,000 at June 30, 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.

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

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 for the second quarter 2012 was $5,685,000, or $0.46 per basic and diluted share, comparable to net income of $0.46 per share for the first quarter 2012 and down slightly from $0.47 per share for the second quarter 2011. For the first six months of 2012, net income was $11,272,000, or $0.92 per basic and diluted share, comparable to $0.92 per share in the first six months of 2011. Annualized return on average assets was 1.72% for the six months ended June 30, 2012, and annualized return on average equity for the same period was 13.12%.

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

- Net interest income in the second quarter 2012 was $146,000 (1.2%) lower than in the first quarter 2012, and $313,000 (2.6%) higher than in the second quarter 2011. For the first six months of 2012, net interest income was $1,305,000 (5.7%) higher than for the first six months of 2011. The interest margin fell slightly to 4.33% in the second quarter 2012 from 4.41% in the first quarter 2012, as yields on earning assets (mainly loans and securities) dropped due in part to falling market interest rates. The higher level of net interest income in the second quarter 2012 and year-to-date June 30, 2012 as compared to the corresponding periods of 2011 reflected significant improvement in the margin, primarily because of a lower cost of funds. Net interest income included the benefit of accretion from the offset of a previous write-down on a security, with a benefit of $855,000 in the first six months of 2012, including $398,000 in the second quarter and $457,000 in the first quarter, as compared to a benefit of $271,000 in the first six months of 2011, with $160,000 in the second quarter 2011 and $111,000 in the first quarter 2011. The security matured in the second quarter 2012, with the Corporation receiving full repayment of principal.

- The provision for loan losses was $367,000 in the second quarter 2012, as compared to a credit (reduction in expense) of $182,000 in the first quarter 2012 and a provision of $31,000 in the second quarter 2011. For the first six months of 2012, the Corporation's provision for loan losses was $185,000 as compared to a credit of $161,000 in the first six months of 2011. In the second quarter 2012, the provision included a net increase in specific allowances for loan losses on larger commercial loans of $177,000, including an increase of $263,000 related to one relationship. 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. The credits for loan losses in the first quarter 2012 and the first six months of 2011 resulted, in part, from a reduction in loans outstanding, as the general component of the allowance for loan losses was reduced in those periods. The credit for the first six months of 2011 also reflected the benefit of lower charge-off amounts than had been anticipated (and for which larger allowances had been established) related to three commercial loan relationships.

- Total noninterest revenue was $4,095,000 in the second quarter 2012, up from $3,759,000 in the first quarter 2012 and $3,673,000 in the second quarter 2011. For the first six months of 2012, total noninterest revenue was $7,854,000 or 26.1% higher than in the first six months of 2011. The increases in noninterest revenue for both the most recent quarter and year-to-date 2012 included significant increases in gains from sales of residential mortgage loans and from brokerage revenues. In April 2012, the Corporation re-opened the Athens, PA branch, which had been closed due to a flood that occurred in September 2011. In the second quarter 2012, noninterest revenue included a gain related to re-opening the Athens branch of approximately $270,000, as the amount of insurance proceeds received exceeded the historical book value of the assets replaced or reconstructed. Also included in noninterest revenue in the second quarter 2012 were losses totaling $184,000 related to real estate properties acquired in foreclosures. 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. Excluding the 2011 impairment loss, as well as the Athens and foreclosed property transactions, noninterest revenue for the first six months of 2012 was $445,000 (6.2%) higher than in the first six months of 2011.

- Net gains from available-for-sale securities totaled $203,000 in the second quarter 2012, as compared to net losses of $2,000 in the first quarter 2012 and net gains of $163,000 in the second quarter 2011. For the first six months of 2012, net securities gains of $201,000 were considerably lower than gains of $2,002,000 in the first six months of 2011. 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 $8,280,000 in the second quarter 2012, down $237,000 from the first quarter 2012 and up $486,000 (6.2%) over the second quarter 2011. For the first six months of 2012, total noninterest expense was $740,000 (4.6%) higher than for the first six months of 2011. The reduction in expenses in the second quarter 2012 as compared to the first quarter includes the effect of lower payroll taxes and other employee benefit expenses that are typically higher in the first quarter than in the remainder of the year. The increase in noninterest expenses in the second quarter 2012 as compared to the second quarter 2011 included a charge of $143,000 related to pre-payment of a $5 million borrowing, which the Corporation funded by selling securities for a net gain of $166,000 and which management expects will result in a slightly favorable impact to the net interest margin in future periods. The increase in noninterest expense in the second quarter 2012 as compared to the second quarter 2011 also reflects increases in salaries and wages of $117,000 (3.4%) as well as increases in software subscriptions and updates, charitable donations and other expenses. The increase in noninterest expense for the six months ended June 30, 2012 as compared to the first six months of 2011 includes an increase in other operating expense of $622,000. Within other operating expenses, the largest increases in the first six months of 2012 included the $143,000 charge for pre-payment of a borrowing described above as well as increases in software subscriptions and updates, legal and professional fees, ATM and debit card processing costs, expenses related to other real estate properties and charitable donations. FDIC assessments were $211,000 lower in the first six months of 2012 than in the first six months of 2011, reflecting the benefit of a change in the FDIC's method for determining assessments that became effective in the second quarter 2011.

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

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TABLE I - QUARTERLY FINANCIAL DATA
(In Thousands)

	June 30, 2012	Mar. 31, 2012	Dec 31, 2011	Sept. 30, 2011	June 30, 2011	Mar. 31, 2011
Interest income	$14,529	$14,776	$15,198	$15,317	$15,443	$15,298
Interest expense	2,401	2,502	2,804	3,108	3,628	4,016
Net interest income	12,128	12,274	12,394	12,209	11,815	11,282
Provision (credit) for loan losses	367	(182)	(87)	(37)	31	(192)
Net Interest income after provision (credit) for loan losses	11,761	12,456	12,481	12,246	11,784	11,474
Other income	4,095	3,759	3,711	3,999	3,673	2,555
Net gains (losses) on available-for-sale securities	203	(2)	188	26	163	1,839
Other expenses	8,280	8,517	7,948	8,052	7,794	8,263
Income before income tax provision	7,779	7,696	8,432	8,219	7,826	7,605
Income tax provision	2,094	2,109	2,291	2,230	2,129	2,064
Net income available to common shareholders	$5,685	$5,587	$6,141	$5,989	$5,697	$5,541
Net income per common share – basic	$0.46	$0.46	$0.51	$0.49	$0.47	$0.46
Net income per common share – diluted	$0.46	$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.

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 allowance for loan losses is provided in a separate section later in Management's Discussion and Analysis. Given the very subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

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

As described in Note 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 and six-month periods ended June 30, 2012 and June 30, 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.

Six-Month Periods Ended June 30, 2012 and 2011

For the six-month periods, fully taxable equivalent net interest income was $26,102,000 in 2012, $1,390,000 (5.6%) higher than in 2011. As shown in Table IV, net changes in volume had the effect of increasing net interest income $397,000 in 2012 compared to 2011, and interest rate changes had the effect of increasing net interest income $993,000. The most significant components of the volume change in net interest income in 2012 were a decrease in interest expense of $519,000 attributable to a reduction in the balance of borrowed funds, a decrease in interest expense of $285,000 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 $488,000 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 $1,929,000 due to lower rates paid on interest-bearing deposits (primarily Individual Retirement Accounts), a decrease in interest income of $567,000 attributable to lower rates earned on loans receivable, and a decrease in interest income of $392,000 attributable to lower rates earned on available-for-sale securities. 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 4.14% in 2012, as compared to 3.84% in 2011.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled $31,005,000 in 2012, a decrease of 4.2% from 2011. Interest and fees on loans receivable decreased $1,055,000, or 4.6%. As indicated in Table III, average available-for-sale securities (at amortized cost) totaled $461,051,000 in 2012, an increase of $2,318,000 (0.5%) from 2011. Net growth in the Corporation's 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 municipal securities. This growth was partially offset by a reduction in the balances 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 4.00% for 2012 and 4.17% in 2011.

The average balance of gross loans receivable decreased 2.4% to $702,625,000 in 2012 from $720,244,000 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 6.23% in 2012 from 6.39% 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 $35,817,000 in 2012 from $30,561,000 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 $4,189,000 for 2012 and totaled $4,720,000 at June 30, 2012. The Corporation held no such investments in the six-month period ended June 30, 2011 or in prior periods.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell $2,741,000, or 35.9%, to $4,903,000 in 2012 from $7,644,000 in 2011. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 1.05% in 2012 from 1.55% in 2011.

Total average deposits (interest-bearing and noninterest-bearing) increased 0.3%, to $1,005,768,000 in 2012 from $1,002,444,000 in 2011. Increases in the average balances of demand deposits and savings accounts were partially offset by decreases in interest checking accounts, certificates of deposit and Individual Retirement Accounts. Consistent with continuing low short-term market interest rates, the average rates incurred on deposit accounts have decreased significantly in 2012 as compared to 2011.

Variable-rate accounts made up $133,726,000 of the average balance in Individual Retirement Accounts in 2012 and $148,128,000 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 0.65% at June 30, 2012. As shown in Table III, the average rate on Individual Retirement Accounts decreased to 0.94% in 2012 from 2.73% in 2011.

Total average borrowed funds decreased $37,697,000 to $120,990,000 in 2012 from $158,687,000 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 $4,255,000 in 2012 from $18,143,000 in 2011 primarily as a result of changes to service charges assessed on related business checking accounts. In 2012, the Corporation took three short-term advances from the Federal Home Loan Bank of Pittsburgh (FHLB) to offset seasonal declines in deposit balances. Short-term advances averaged $2,281,000 in 2012 with no such advances outstanding during 2011. The short-term advances matured, and none were outstanding at June 30, 2012. The average rate on borrowed funds was 3.79% in 2012, compared to 3.57% in 2011.

Three-Month Periods Ended June 30, 2012 and 2011

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

For the three-month periods, fully taxable equivalent net interest income was $12,979,000 in 2012, $352,000 (2.8%) higher than in 2011. As shown in Table IV, net changes in volume had the effect of increasing net interest income $126,000 in 2012 compared to 2011, and interest rate changes had the effect of increasing net interest income $226,000. As presented in Table III, the “Interest Rate Spread” was 4.10% in 2012, as compared to 3.92% in 2011.

Interest income totaled $15,380,000 in 2012, a decrease of 5.4% from 2011. Income from available-for-sale securities decreased $317,000 (6.6%), while interest and fees from loans receivable decreased $590,000, or 5.2%. As indicated in Table III, total average available-for-sale securities (at amortized cost) in 2012 increased slightly to $463,366,000 from $463,338,000 in 2011. The average rate of return on available-for-sale securities was 3.92% for 2012 and 4.18% in 2011. For the three-month period, the average balance of gross loans receivable decreased 1.9% to $703,096,000 in 2012 from $716,481,000 in 2011. The average rate of return on loans was 6.18% in 2012 and 6.39% in 2011.

The average balance of interest-bearing due from banks increased to $37,300,000 in 2012 from $29,385,000 in 2011. This category includes balances held by the Federal Reserve, and it also includes the Corporation’s investment in FDIC-insured certificates of deposit issued by other financial institutions, which averaged $4,287,000 for 2012. The Corporation held no such investments in the three-month period ended June 30, 2011 or in prior periods.

For the three-month period, interest expense fell $1,227,000, or 33.8%, to $2,401,000 in 2012 from $3,628,000 in 2011. Total average deposits (interest-bearing and noninterest-bearing) increased 0.8%, to $1,011,232,000 in 2012 from $1,002,866,000 in 2011. Total average borrowed funds decreased $35,800,000 to $118,951,000 in 2012 from $154,751,000 in 2011.

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TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE

(In Thousands)	Three Months Ended June 30, 2012	2011	Increase/ (Decrease)	Six Months Ended June 30, 2012	2011	Increase/ (Decrease)
INTEREST INCOME						
Available-for-sale securities:						
Taxable	$ 2,593	$ 2,910	$ (317)	$ 5,326	$ 5,665	$ (339)
Tax-exempt	1,921	1,921	0	3,837	3,826	11
Total available-for-sale securities	4,514	4,831	(317)	9,163	9,491	(328)
Interest-bearing due from banks	31	16	15	59	32	27
Loans held for sale	23	6	17	32	27	5
Loans receivable:						
Taxable	10,242	10,848	(606)	20,608	21,695	(1,087)
Tax-exempt	570	554	16	1,143	1,111	32
Total loans receivable	10,812	11,402	(590)	21,751	22,806	(1,055)
Total Interest Income	15,380	16,255	(875)	31,005	32,356	(1,351)
INTEREST EXPENSE						
Interest-bearing deposits:						
Interest checking	50	117	(67)	101	247	(146)
Money market	97	140	(43)	194	291	(97)
Savings	27	48	(21)	53	104	(51)
Certificates of deposit	770	1,001	(231)	1,596	2,042	(446)
Individual Retirement Accounts	326	960	(634)	676	2,149	(1,473)
Other time deposits	1	1	0	1	2	(1)
Total interest-bearing deposits	1,271	2,267	(996)	2,621	4,835	(2,214)
Borrowed funds:						
Short-term	1	8	(7)	4	14	(10)
Long-term	1,129	1,353	(224)	2,278	2,795	(517)
Total borrowed funds	1,130	1,361	(231)	2,282	2,809	(527)
Total Interest Expense	2,401	3,628	(1,227)	4,903	7,644	(2,741)
Net Interest Income	$ 12,979	$ 12,627	$ 352	$ 26,102	$ 24,712	$ 1,390

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 Ended 6/30/2012 Average Balance	Rate of Return/ Cost of Funds %	3 Months Ended 6/30/2011 Average Balance	Rate of Return/ Cost of Funds %	6 Months Ended 6/30/2012 Average Balance	Rate of Return/ Cost of Funds %	6 Months Ended 6/30/2011 Average Balance	Rate of Return/ Cost of Funds %
EARNING ASSETS								
Available-for-sale securities, at amortized cost:								
Taxable	$333,255	3.13 %	$335,289	3.48 %	$332,131	3.22 %	$331,219	3.45 %
Tax-exempt	130,111	5.94 %	128,049	6.02 %	128,920	5.99 %	127,514	6.05 %
Total available-for-sale securities	463,366	3.92 %	463,338	4.18 %	461,051	4.00 %	458,733	4.17 %
Interest-bearing due from banks	37,300	0.33 %	29,385	0.22 %	35,817	0.33 %	30,561	0.21 %
Loans held for sale	1,865	4.96 %	342	7.04 %	1,461	4.40 %	1,028	5.30 %
Loans receivable:								
Taxable	666,752	6.18 %	681,333	6.39 %	666,344	6.22 %	684,277	6.39 %
Tax-exempt	36,344	6.31 %	34,806	6.38 %	36,281	6.34 %	34,939	6.41 %
Total loans receivable	703,096	6.18 %	716,481	6.39 %	702,625	6.23 %	720,244	6.39 %
Total Earning Assets	1,205,627	5.13 %	1,209,204	5.39 %	1,200,954	5.19 %	1,209,538	5.39 %
Cash	17,791		17,631		17,341		17,310	
Unrealized gain/loss on securities	17,545		5,805		17,734		2,626	
Allowance for loan losses	(7,435)		(8,938)		(7,587)		(9,069)	
Bank premises and equipment	18,908		22,114		18,903		22,293	
Intangible Asset - Core Deposit Intangible	186		287		195		301	
Intangible Asset - Goodwill	11,942		11,942		11,942		11,942	
Other assets	47,046		56,349		47,664		58,541	
Total Assets	$1,311,610		$1,314,394		$1,307,146		$1,313,482	
INTEREST-BEARING LIABILITIES								
Interest-bearing deposits:								
Interest checking	$156,994	0.13 %	$166,795	0.28 %	$159,259	0.13 %	$165,146	0.30 %

Money market	210,646	0.19 %	207,266	0.27 %	208,256	0.19 %	205,363	0.29 %
Savings	107,514	0.10 %	95,821	0.20 %	106,023	0.10 %	94,232	0.22 %
Certificates of deposit	199,320	1.55 %	205,346	1.96 %	195,622	1.64 %	208,721	1.97 %
Individual Retirement Accounts	144,095	0.91 %	156,611	2.46 %	145,168	0.94 %	158,880	2.73 %
Other time deposits	1,314	0.31 %	1,350	0.30 %	1,128	0.18 %	1,154	0.35 %
Total interest-bearing deposits	819,883	0.62 %	833,189	1.09 %	815,456	0.65 %	833,496	1.17 %
Borrowed funds:								
Short-term	5,650	0.07 %	19,407	0.17 %	6,536	0.12 %	18,143	0.16 %
Long-term	113,301	4.01 %	135,344	4.01 %	114,454	4.00 %	140,544	4.01 %
Total borrowed funds	118,951	3.82 %	154,751	3.53 %	120,990	3.79 %	158,687	3.57 %
Total Interest-bearing Liabilities	938,834	1.03 %	987,940	1.47 %	936,446	1.05 %	992,183	1.55 %
Demand deposits	191,349		169,677		190,312		168,948	
Other liabilities	7,774		6,998		8,613		6,731	
Total Liabilities	1,137,957		1,164,615		1,135,371		1,167,862	
Stockholders' equity, excluding other comprehensive income/loss	162,721		146,267		160,761		144,172	
Other comprehensive income/loss	10,932		3,512		11,014		1,448	
Total Stockholders' Equity	173,653		149,779		171,775		145,620	
Total Liabilities and Stockholders' Equity	$1,311,610		$1,314,394		$1,307,146		$1,313,482	
Interest Rate Spread		4.10 %		3.92 %		4.14 %		3.84 %
Net Interest Income/Earning Assets		4.33 %		4.19 %		4.37 %		4.12 %
Total Deposits (Interest-bearing and Demand)	$1,011,232		$1,002,866		$1,005,768		$1,002,444	

(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.

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TABLE IV - ANALYSIS OF VOLUME AND RATE CHANGES

(In Thousands)	3 Months Ended 6/30/12 vs. 6/30/11			6 Months Ended 6/30/12 vs. 6/30/11		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
EARNING ASSETS						
Available-for-sale securities:						
Taxable	$ (23)	$ (294)	$ (317)	$ 17	$ (356)	$ (339)
Tax-exempt	29	(29)	0	47	(36)	11
Total available-for-sale securities	6	(323)	(317)	64	(392)	(328)
Interest-bearing due from banks	6	9	15	7	20	27
Loans held for sale	16	1	17	10	(5)	5
Loans receivable:						
Taxable	(251)	(355)	(606)	(533)	(554)	(1,087)
Tax-exempt	23	(7)	16	45	(13)	32
Total loans receivable	(228)	(362)	(590)	(488)	(567)	(1,055)
Total Interest Income	(200)	(675)	(875)	(407)	(944)	(1,351)
INTEREST-BEARING LIABILITIES						
Interest-bearing deposits:						
Interest checking	(7)	(60)	(67)	(9)	(137)	(146)
Money market	2	(45)	(43)	4	(101)	(97)
Savings	6	(27)	(21)	12	(63)	(51)
Certificates of deposit	(30)	(201)	(231)	(121)	(325)	(446)
Individual Retirement Accounts	(70)	(564)	(634)	(171)	(1,302)	(1,473)
Other time deposits	0	0	0	0	(1)	(1)
Total interest-bearing deposits	(99)	(897)	(996)	(285)	(1,929)	(2,214)
Borrowed funds:						
Short-term	(3)	(4)	(7)	(7)	(3)	(10)
Long-term	(224)	0	(224)	(512)	(5)	(517)
Total borrowed funds	(227)	(4)	(231)	(519)	(8)	(527)
Total Interest Expense	(326)	(901)	(1,227)	(804)	(1,937)	(2,741)
Net Interest Income	$ 126	$ 226	$ 352	$ 397	$ 993	$ 1,390

(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.

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RECOVERY ON IMPAIRED INVESTMENT SECURITY

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

In the fourth quarter 2010, The Toronto-Dominion Bank acquired The South Financial Group, Inc., made a payment for the full amount of previously deferred interest, and resumed quarterly payments on the security. The Corporation recognized a material change in the expected cash flows and began recording accretion income (included in interest income) to offset the previous OTTI charges as an adjustment to the security's yield over its remaining life. The yield to maturity was 147.03%. The security had a face amount of $2,000,000 and matured in May 2012.

The amounts of accretion income from this security are as follows:

	Accretion of Prior OTTI
4th Quarter 2010	$ 83
1st Quarter 2011	111
2nd Quarter 2011	160
3rd Quarter 2011	229
4th Quarter 2011	325
1st Quarter 2012	457
2nd Quarter 2012	398
Total	$ 1,763

Excluding interest income (including accretion) and the average balance of this security from the calculations used to determine Tables II, III and IV, the interest rate spread and interest margin (fully taxable equivalent net interest income divided by average total earning assets) would be as follows:

	3 Months Ended		6 Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Interest rate spread:				

Actual from Table III	4.10 %	3.92 %	4.14 %	3.84 %
Excluding Carolina First security	3.97 %	3.86 %	4.00 %	3.79 %
Interest margin:				
Actual from Table III	4.33 %	4.19 %	4.37 %	4.12 %
Excluding Carolina First security	4.20 %	4.13 %	4.23 %	4.07 %

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TABLE V - COMPARISON OF NONINTEREST INCOME (In Thousands)	6 Months Ended June 30, 2012	2011	$ Change	% Change
Service charges on deposit accounts	$2,417	$2,356	$61	2.6
Service charges and fees	455	425	30	7.1
Trust and financial management revenue	1,889	1,823	66	3.6
Brokerage revenue	456	352	104	29.5
Insurance commissions, fees and premiums	107	126	(19)	(15.1)
Interchange revenue from debit card transactions	983	937	46	4.9
Net gains from sales of loans	638	414	224	54.1
Increase in cash surrender value of life insurance	236	254	(18)	(7.1)
Net (loss) from other real estate	(80)	(43)	(37)	86.0
Net gain from premises and equipment	270	0	270	
Impairment loss on limited partnership investment	0	(948)	948	(100.0)
Other operating income	483	532	(49)	(9.2)
Total other operating income before realized gains on available-for-sale securities, net	$7,854	$6,228	$1,626	26.1

NONINTEREST INCOME - SIX MONTHS ENDED JUNE 30, 2012 AND 2011

Table V excludes realized gains on available-for-sale securities, which are discussed in the "Earnings Overview" section of Management's Discussion and Analysis. Total noninterest income shown in Table V increased $1,626,000 or 26.1%, in the first six months of 2012 as compared to the first six months of 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 $1,029,000 at June 30, 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.

- Brokerage revenue increased $104,000, or 29.5%, reflecting increased sales of annuities used by customers as investment vehicles in retirement.

- Net gains from sales of loans increased $224,000. Starting in late 2009, the Corporation began to sell a significant amount of residential mortgage loans into the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The increase in revenue from sales in 2012 reflects the impact of significant refinancing activity, as market interest rates have continued to fall throughout most of the time frame since the Corporation began to offer the program.

- The net gain from premises and equipment of $270,000 in 2012 included a gain of $272,000 from the excess of insurance proceeds received over the historical book value of assets replaced or reconstructed at the Athens, PA branch, which was damaged by a flood in September 2011 and remained closed until it was re-opened in April 2012. Total insurance proceeds associated with the reconstruction project amounted to $608,000, including $154,000 for reimbursement of clean-up and other expenses, with the gain determined based on the excess of insurance proceeds for reconstruction and replacement of equipment totaling $454,000 over the net book value of items replaced totaling $182,000.

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TABLE VI - COMPARISON OF NONINTEREST INCOME (In Thousands)	3 Months Ended June 30, 2012	2011	$ Change	% Change
Service charges on deposit accounts	$ 1,256	$ 1,225	$ 31	2.5
Service charges and fees	235	207	28	13.5
Trust and financial management revenue	960	946	14	1.5
Brokerage revenue	288	229	59	25.8
Insurance commissions, fees and premiums	73	58	15	25.9
Interchange revenue from debit card transactions	488	485	3	0.6
Net gains from sales of loans	373	155	218	140.6
Increase in cash surrender value of life insurance	117	132	(15)	(11.4)
Net loss from other real estate	(184)	(24)	(160)	666.7
Net gain from premises and equipment	270	0	270	
Other operating income	219	260	(41)	(15.8)
Total other operating income before realized gains on available-for-sale securities, net	$ 4,095	$ 3,673	$ 422	11.5

NONINTEREST INCOME - THREE MONTHS ENDED JUNE 30, 2012 AND 2011

As presented in Table VI, total noninterest income (excluding realized gains on available-for-sale securities) increased $422,000 or 11.5%, in the second quarter 2012 as compared to the second quarter 2011. The most significant variances are as follows:

- As described in the discussion of noninterest income for the six month periods ended June 30, 2012 and 2011, brokerage revenue increased $59,000, or 25.8%, mainly from an increase in sales of annuities.

- Also as described above, gains from sales of loans increased $218,000, with all of the gains resulting from sales of residential mortgage loans under the MPF Xtra program.

- The net loss from other real estate in the second quarter 2012 of $184,000 included write-downs of the carrying values of two properties totaling $97,000 based on updated valuations from new appraisals, and losses totaling $87,000 from adjustments to amounts payable to the U.S. Small Business Administration related to sales of two commercial properties that took place in 2011.

- As described in the discussion of noninterest income for the six month periods ended June 30, 2012 and 2011, the $270,000 net gain from premises and equipment in the second quarter 2012 included a gain of $272,000 from the excess of insurance proceeds received over the historical book value of assets replaced or reconstructed at the Athens, PA branch, which was damaged by a flood in September 2011 and remained closed until it was re-opened in April 2012.

TABLE VII - COMPARISON OF NONINTEREST EXPENSE

(In Thousands)	6 Months Ended June 30, 2012	2011	$ Change	% Change
Salaries and wages	$7,161	$6,870	$ 291	4.2
Pensions and other employee benefits	2,456	2,324	132	5.7
Occupancy expense, net	1,264	1,397	(133)	(9.5)
Furniture and equipment expense	943	937	6	0.6
FDIC Assessments	303	514	(211)	(41.1)
Pennsylvania shares tax	672	639	33	5.2
Other operating expense	3,998	3,376	622	18.4
Total Other Expense	$16,797	$16,057	$ 740	4.6

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NONINTEREST EXPENSE - SIX MONTHS ENDED JUNE 30, 2012 AND 2011

As shown in Table VI, total noninterest expense increased $740,000 or 4.6% in the first six months of 2012 as compared to the first six months of 2011. Significant variances include the following:

- Salaries and wages increased $291,000, or 4.2%, mainly as a result of merit-based salary increases. The number of full-time equivalent employees was 290 at June 30, 2012, up slightly from 289 at June 30, 2011.

- Pensions and other employee benefits increased $132,000, or 5.7%, including an increase of $151,000 (23.8%) in group health insurance expense. The Corporation participates in a health care consortium, and is effectively self-insured for health care costs except for stop loss insurance coverage for catastrophic expenses in excess of defined levels. The increase in health insurance expense in 2012 over 2011 reflects a higher amount of claims incurred. Unemployment compensation and employee tuition expenses were lower in the first six months of 2012 than in the first six months of 2011.

- Occupancy expense decreased $133,000, or 9.5%. Within this category, snow removal and related expenses were $48,000 lower in 2012, reflecting the milder winter weather throughout the Corporation's market area. Depreciation expense was $86,000 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 $75,000 lower in the first six months of 2012 than in the first six months of 2011.

- FDIC Assessments decreased $211,000, or 41.1%. 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 was 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 $622,000, or 18.4%. This category includes many different types of expenses, with the most significant differences in amounts between the first six months of 2012 and 2011 as follows:

Ø The Corporation incurred a charge of $143,000 in the second quarter 2012 related to pre-payment of a $5 million borrowing, with the pre-payment funded by proceeds from selling available-for-sale securities for a net gain of $166,000. Management expects the net impact of the sales of securities and pre-payment of the borrowing to be slightly favorable to the net interest margin over the next several quarters.

Ø Software-related subscriptions and updates, mainly related to lending-related activities, up $131,000, or 41.7%

Ø Fees paid related to interchange and ATM processing, up $70,000, or 14.2%

- Ø Expenses associated with other real estate properties, up $64,000
- Ø Professional fees, up $62,000, or 34.6%, including costs associated with training and implementation of lending-related software changes and customer service training
- Ø Charitable donations, up $53,000, and
- Ø Attorney fees, up $53,000, mainly related to lending-related and other matters not related to litigation.

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TABLE VIII - COMPARISON OF NONINTEREST EXPENSE

(In Thousands)

	3 Months Ended June 30, 2012	2011	$ Change	% Change
Salaries and wages	$3,586	$3,469	$ 117	3.4
Pensions and other employee benefits	1,090	1,018	72	7.1
Occupancy expense, net	628	665	(37)	(5.6)
Furniture and equipment expense	461	453	8	1.8
FDIC Assessments	157	189	(32)	(16.9)
Pennsylvania shares tax	340	320	20	6.3
Other operating expense	2,018	1,680	338	20.1
Total Other Expense	$8,280	$7,794	$ 486	6.2

NONINTEREST EXPENSE - THREE MONTHS ENDED JUNE 30, 2012 AND 2011

Total noninterest expense was $486,000, or 6.2%, higher in the second quarter 2012 as compared to the second quarter 2011. Significant changes include the following:

· Salaries and wages increased $117,000, or 3.4%, mainly as a result of merit-based salary increases.

· Pensions and other employee benefits increased $72,000, or 7.1%, including an increase of $83,000 (24.8%) in group health insurance expense, mainly as a result of higher total claims incurred in 2012.

· Other operating expense increased $338,000, or 20.1%, in the second quarter 2012 as compared to the second quarter 2011. The most significant differences in individual types of expenses within this category between the second quarters of 2012 and 2011 are as follows:

Ø As described in the comparison of expenses for the six month periods ended June 30, 2012 and 2011, the Corporation incurred a charge of $143,000 in the second quarter 2012 related to pre-payment of a $5 million borrowing, with the pre-payment funded by proceeds from selling available-for-sale securities for a net gain of $166,000.

Ø Software-related subscriptions and updates, mainly related to lending-related activities, up $57,000, or 33.7%

Ø Charitable donations, up $44,000

Ø Fees paid related to interchange and ATM processing, up $38,000, or 15.1%

Ø Professional fees, up $37,000, or 40.2%, including costs associated with training and implementation of lending-related software changes and customer service training, and

Ø Attorney fees, up $34,000, mainly related to lending-related and other matters not related to litigation.

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 was $7,657,000 at June 30, 2012, down slightly from $7,705,000 at December 31, 2011. As shown in Table X, the specific allowance on impaired loans totaled $1,303,000 at June 30, 2012, which was $177,000 higher than the total specific allowance at December 31, 2011. In the second quarter 2012, the estimated allowance required for loans to one commercial borrower increased $237,000 based on management's updated assessment of the borrower's prospects for repayment and the estimated net selling price of real estate collateral. Table X also shows the collectively determined component of the allowance for commercial loans fell by $165,000 as of June 30, 2012 compared to December 31, 2011. The collectively determined allowance for the commercial segment was lower because the net charge-off percentage used to determine a portion of the collectively determined allowance was lower in the first six months of 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 collectively determined portion of the allowance on residential mortgage loans was $59,000 lower at June 30, 2012 than at December 31, 2011, mainly because outstanding loans were lower. 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 for any of the segments, at June 30, 2012 as compared to December 31, 2011.

As shown in Table IX, the Corporation recorded a provision for loan losses of $185,000 in the first six months of 2012 as compared to a credit for loan losses of $161,000 in the first six months of 2011. The provision for loan losses in the first six months of 2012 included a provision of $367,000 in the second quarter, due mainly to the $237,000 increase in allowance required on one commercial loan relationship, as described above, as well as an increase in the collectively determined allowance required on commercial loans due to an increase in loans outstanding. The credit for loan losses in the first six months of 2011 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 and lower charge-offs than previously established allowances related to two other commercial loan relationships. Also, collectively determined allowances were lower at June 30, 2011 than at December 31, 2010 as a result of lower outstanding loan balances. The total amount of the provision or credit 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 or credit for loan losses and activity in the allowance for loan losses, by segment and class, for the three-month and six-month periods ended June 30, 2012 and 2011.

Table XI presents information related to past due and impaired loans, and loans that have been modified under terms that are considered troubled debt restructurings (TDRs). Table XI shows total impaired loans of $6,861,000 at June 30, 2012 was $1,003,000 lower than the amount at December 31, 2011, primarily because of pay-downs received. Table XI also reflects 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. Total nonperforming loans of $8,591,000, or 1.22% of total loans outstanding, at June 30, 2012 was slightly higher than total nonperforming loans of 1.19% of loans at December 31, 2011, and within the range of 1.11% to 1.58% year-end levels from 2007 through of 2011. Total nonperforming assets of $9,495,000, or 0.72% of total assets, at June 30, 2012 was slightly lower than the level at December 31, 2011, and within the range of 0.66% to 0.92% based on year-end levels from 2007 through 2011. The allowance for loan losses was 1.09% of total loans outstanding at June 30, 2012, which was the same percentage at December 31, 2011, and the allowance as a percentage of nonperforming loans was 89.13% at June 30, 2012, down slightly from 91.03% at December 31, 2011. Each period presented in Table XI includes a few large commercial relationships that have required significant monitoring and workout efforts. As a result, a limited number of relationships may significantly impact the total amount of allowance required on impaired loans, and may significantly impact the amount of total charge-offs reported in any one period.

As shown in Table XI, loans classified as TDRs were higher at June 30, 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.

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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 June 30, 2012. The outstanding balance of the loans was $466,000 at June 30, 2012. The loans were in nonaccrual status at June 30, 2012 and December 31, 2011. At June 30, 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 June 30, 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 June 30, 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 IX through XII present historical data related to the allowance for loan losses.

TABLE IX - ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

(In Thousands)

	6 Months Ended						
	June 30,	June 30,	Years Ended December 31,				
	2012	2011	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	(188)	(79)	(100)	(340)	(146)	(173)	(149)
Commercial	(35)	(734)	(1,189)	(91)	(39)	(1,607)	(174)
Consumer	(68)	(84)	(157)	(188)	(293)	(259)	(221)
Total charge-offs	(291)	(897)	(1,446)	(619)	(478)	(2,039)	(544)
Recoveries:							
Residential mortgage	18	0	3	55	8	19	5
Commercial	5	177	255	113	77	22	31
Consumer	35	43	71	102	121	87	50
Total recoveries	58	220	329	270	206	128	86
Net charge-offs	(233)	(677)	(1,117)	(349)	(272)	(1,911)	(458)
Allowance for loan losses recorded in acquisition	0	0	0	0	0	0	587
Provision (credit) for loan losses	185	(161)	(285)	1,191	680	909	529
Balance, end of period	$7,657	$ 8,269	$7,705	$9,107	$8,265	$7,857	$8,859

Net charge-offs as a % of average loans	0.03 %	0.09 %	0.16 %	0.05 %	0.04 %	0.26 %	0.06 %

TABLE X - COMPONENTS OF THE ALLOWANCE FOR LOAN LOSSES

(In Thousands)	As of June 30,	As of December 31,				
	2012	2011	2010	2009	2008	2007
ASC 310 - Impaired loans	$ 1,303	$1,126	$2,288	$1,126	$456	$2,255
ASC 450 - Collective segments:						
Commercial	2,646	2,811	3,047	2,677	2,654	1,870
Residential mortgage	3,071	3,130	3,227	3,859	3,920	4,201
Consumer	201	204	232	281	399	533
Unallocated	436	434	313	322	428	0
Total Allowance	$ 7,657	$7,705	$9,107	$8,265	$7,857	$8,859

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TABLE XI – PAST DUE AND IMPAIRED LOANS, NONPERFORMING ASSETS

AND TROUBLED DEBT RESTRUCTURINGS (TDRs)

(In Thousands)

	As of June 30, 2012	As of December 31, 2011	2010	2009	2008	2007
Impaired loans with a valuation allowance	$ 3,434	$ 3,433	$ 5,457	$ 2,690	$ 2,230	$ 5,361
Impaired loans without a valuation allowance	3,427	4,431	3,191	3,257	3,435	857
Total impaired loans	$ 6,861	$ 7,864	$ 8,648	$ 5,947	$ 5,665	$ 6,218
Total loans past due 30-89 days and still accruing	$ 5,191	$ 7,898	$ 7,125	$ 9,445	$ 9,875	$ 10,822
Nonperforming assets:						
Total nonaccrual loans	$ 7,447	$ 7,197	$ 10,809	$ 9,092	$ 7,200	$ 6,955
Total loans past due 90 days or more and still accruing	1,144	1,267	727	31	1,305	1,200
Total nonperforming loans	8,591	8,464	11,536	9,123	8,505	8,155
Foreclosed assets held for sale (real estate)	904	1,235	537	873	298	258
Total nonperforming assets	$ 9,495	$ 9,699	$ 12,073	$ 9,996	$ 8,803	$ 8,413
Loans subject to troubled debt restructurings (TDRs):						
Performing	$ 925	$ 1,064	$ 645	$ 326	$ 0	$ 0
Nonperforming	1,754	2,413	0	0	0	0
Total TDRs	$ 2,679	$ 3,477	$ 645	$ 326	$ 0	$ 0
Total nonperforming loans as a % of loans	1.22 %	1.19 %	1.58 %	1.27 %	1.14 %	1.11 %
Total nonperforming assets as a % of assets	0.72 %	0.73 %	0.92 %	0.76 %	0.69 %	0.66 %
Allowance for loan losses as a % of total loans	1.09 %	1.09 %	1.25 %	1.15 %	1.06 %	1.20 %
Allowance for loan losses as a % of nonperforming loans	89.13 %	91.03 %	78.94 %	90.60 %	92.38 %	108.63 %

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TABLE XII - SUMMARY OF LOANS BY TYPE

Summary of Loans by Type (In Thousands)	June 30, 2012	As of December 31, 2011	2010	2009	2008	2007
Residential mortgage:						
Residential mortgage loans - first liens	$321,163	$331,015	$333,012	$340,268	$353,909	$363,467
Residential mortgage loans - junior liens	27,404	28,851	31,590	35,734	40,657	40,392
Home equity lines of credit	31,858	30,037	26,853	23,577	21,304	20,542
1-4 Family residential construction	10,699	9,959	14,379	11,452	11,262	4,742
Total residential mortgage	391,124	399,862	405,834	411,031	427,132	429,143
Commercial:						
Commercial loans secured by real estate	164,771	156,388	167,094	163,483	165,979	144,742
Commercial and industrial	52,704	57,191	59,005	49,753	48,295	52,241
Political subdivisions	36,858	37,620	36,480	37,598	38,790	33,013
Commercial construction	26,517	23,518	24,004	15,264	13,730	17,755
Loans secured by farmland	10,079	10,949	11,353	11,856	9,140	8,287
Multi-family (5 or more) residential	6,409	6,583	7,781	8,338	8,367	9,004
Agricultural loans	3,263	2,987	3,472	3,848	4,495	3,553
Other commercial loans	563	552	392	638	884	1,010
Total commercial	301,164	295,788	309,581	290,778	289,680	269,605
Consumer	12,146	12,665	14,996	19,202	26,732	37,193
Total	704,434	708,315	730,411	721,011	743,544	735,941
Less: allowance for loan losses	(7,657)	(7,705)	(9,107)	(8,265)	(7,857)	(8,859)
Loans, net	$696,777	$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 June 30, 2012, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling $44,523,000.

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 $29,281,000 at June 30, 2012.

The Corporation's outstanding, available, and total credit facilities at June 30, 2012 and December 31, 2011 are as follows:

	Outstanding		Available		Total Credit	
(In Thousands)	June 30, 2012	Dec. 31, 2011	June 30, 2012	Dec. 31, 2011	June 30, 2012	Dec. 31, 2011
Federal Home Loan Bank of Pittsburgh	$30,038	$40,363	$295,860	$292,304	$325,898	$332,667
Federal Reserve Bank Discount Window	0	0	28,158	27,438	28,158	27,438
Other correspondent banks	0	0	45,000	25,000	45,000	25,000
Total credit facilities	$30,038	$40,363	$369,018	$344,742	$399,056	$385,105

At June 30, 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.

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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 June 30, 2012, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was $216,200,000.

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 June 30, 2012 and December 31, 2011 are presented below. Management believes, as of June 30, 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
June 30, 2012:						
Total capital to risk-weighted assets:						
Consolidated	$160,036	22.53%	$56,836	³8 %	n/a	n/a
C&N Bank	147,313	20.97%	56,203	³8 %	$ 70,253	³10 %
Tier 1 capital to risk-weighted assets:						
Consolidated	151,291	21.29%	28,418	³4 %	n/a	n/a
C&N Bank	139,590	19.87%	28,101	³4 %	42,152	³6 %
Tier 1 capital to average assets:						
Consolidated	151,291	11.79%	51,312	³4 %	n/a	n/a
C&N Bank	139,590	10.92%	51,136	³4 %	63,920	³5 %
December 31, 2011:						
Total capital to risk-weighted assets:						
Consolidated	$149,898	21.17%	$56,636	³8 %	n/a	n/a
C&N Bank	137,717	19.66%	56,046	³8 %	$ 70,058	³10 %
Tier 1 capital to risk-weighted assets:						
Consolidated	141,255	19.95%	28,318	³4 %	n/a	n/a
C&N Bank	129,978	18.55%	28,023	³4 %	42,035	³6 %
Tier 1 capital to average assets:						
Consolidated	141,255	10.93%	51,712	³4 %	n/a	n/a

C&N Bank	129,978	10.14 %	51,285	³4 %	64,107	³5 %

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

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

The Corporation’s total stockholders’ equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in “Accumulated Other Comprehensive Income (Loss)” within stockholders’ equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains on available-for-sale securities, net of deferred income tax, amounted to $11,519,000 at June 30, 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 June 30, 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 ($465,000) at June 30, 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 and six-month periods ended June 30, 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 $12,166,000 for the six months ended June 30, 2012 as compared to $17,825,000 in the first six months of 2011. Although net income was slightly higher for the first six months of 2012 than in the first six months of 2011, Comprehensive Income was lower in the first six months of 2012 because the amount of unrealized gains on available-for-sale securities, net of deferred income tax, was $728,000 as compared to $6,650,000 in the first six months of 2011. Similarly, while net income for the second quarter 2012 was only $12,000 lower than second quarter 2011 net income, Comprehensive Income of $6,365,000 for the second quarter 2012 was $3,160,000 lower than for the second quarter 2011, mainly because the amount of unrealized gains on available-for-sale securities, net of tax, was lower in the second quarter 2012 than in the second quarter 2011.

INCOME TAXES

The effective income tax rate was approximately 27% of pre-tax income for each of the three-month and six-month periods ended June 30, 2012. The provision for income tax for the interim periods is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At June 30, 2012, the net deferred tax asset was $3,962,000, down from the balance at December 31, 2011 of $6,173,000. The main reasons for the decrease in net deferred tax asset included: (1) reduction in deferred tax asset related to general business credit carryforwards, which fell to $0 at June 30, 2012 from $831,000 at December 31, 2011; (2) reduction in deferred tax asset related to the credit for alternative minimum tax (AMT) paid in prior periods, which decreased to $4,070,000 at June 30, 2012 from $4,569,000 at December 31, 2011; and (3) increase in deferred tax liability associated with unrealized gains on available-for-sale securities to $6,201,000 at June 30, 2012 from $5,559,000 at December 31, 2011. The reduction in deferred tax assets for general business credit carryforwards and the credit for AMT resulted from the estimated excess of the Corporation's regular tax liability over the AMT liability for the first six months of 2012, as results for the first six months of 2012 indicate the credits would be fully utilized and a portion of the credit for prior years' AMT paid would be realized.

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

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 mid-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.

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

Table XIII, which follows this discussion, is based on the results of calculations performed using the simulation model as of May 31, 2012 and October 31, 2011. The table shows that as of May 31, 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 0.47% at May 31, 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.

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TABLE XIII - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES

May 31, 2012 Data
(In Thousands) Period Ending May 31, 2013

Basis Point Change in Rates	Interest Income	Interest Expense	Net Interest Income (NII)	NII % Change	NII Risk Limit
+400	$62,980	$ 27,471	$ 35,509	-18.2 %	25.0 %
+300	60,395	22,265	38,130	-12.2 %	20.0 %
+200	57,736	17,606	40,130	-7.6 %	15.0 %
+100	54,982	13,065	41,917	-3.5 %	10.0 %
0	51,950	8,524	43,426	0.0 %	0.0 %
-100	48,699	7,416	41,283	-4.9 %	10.0 %
-200	47,737	7,412	40,325	-7.1 %	15.0 %
-300	47,422	7,412	40,010	-7.9 %	20.0 %
-400	47,295	7,412	39,883	-8.2 %	25.0 %

Market Value of Portfolio Equity at May 31, 2012

Basis Point Change in Rates	Present Value Equity	Present Value % Change	Present Value Risk Limit
+400	$160,386	-22.5 %	50.0 %
+300	174,800	-15.5 %	45.0 %
+200	187,641	-9.3 %	35.0 %
+100	198,721	-4.0 %	25.0 %
0	206,901	0.0 %	0.0 %
-100	202,348	-2.2 %	25.0 %
-200	221,286	7.0 %	35.0 %
-300	257,785	24.6 %	45.0 %
-400	297,821	43.9 %	50.0 %

October 31, 2011 Data
(In Thousands) Period Ending October 31, 2012

Basis Point Change in Rates	Interest Income	Interest Expense	Net Interest Income (NII)	NII % Change	NII Risk 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 Change in Rates	Present Value Equity	Present Value % Change	Present Value Risk Limit
+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 %

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 second quarter 2012. The Corporation recognized no OTTI losses related to bank stocks in the first six months of 2011.

Equity securities held as of June 30, 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 XIV does not reflect the effects of any appreciation in value that may occur, nor does it present the Corporation's maximum exposure to loss on equity securities, which would be 100% of their fair value as of June 30, 2012.

TABLE XIV - EQUITY SECURITIES RISK

(In Thousands)

	June 30, 2012	Dec. 31, 2011
Cost	$ 6,208	$ 5,643
Fair Value	8,626	7,728
Hypothetical 10% Decline In Market Value	(863)	(773)
Hypothetical 20% Decline In Market Value	(1,725)	(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.

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings
The Corporation and C&N Bank are involved in various legal proceedings incidental to their business. Management believes the aggregate liability, if any, resulting from such pending and threatened legal proceedings will not have a material, adverse effect on the Corporation's financial condition or results of operations.

Item 1A. Risk Factors
There have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation's Form 10-K filed 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 June 30, 2012, the maximum additional value available for purchases under this program was $980,694.

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

Item 3. Defaults Upon Senior Securities
None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

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Item 6. Exhibits

2. Plan of acquisition, reorganization, arrangement, liquidation or succession	Not applicable
3. (i) Articles of Incorporation	Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed September 21, 2009
3. (ii) By-laws	Incorporated by reference to Exhibit 3.2 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:	
31.1 Certification of Chief Executive Officer	Filed herewith
31.2 Certification of Chief Financial Officer	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
95. Mine safety disclosure exhibit	Not applicable

99. Additional exhibits	Not applicable
100. XBRL-related documents	Not applicable
101. Interactive data file	Furnished herewith*

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

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Signatures

SIGNATURES

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

	CITIZENS & NORTHERN CORPORATION	
August 7, 2012	By:	/s/ Charles H. Updegraff, Jr.
Date		President and Chief Executive Officer
August 7, 2012	By:	/s/ Mark A. Hughes
Date		Treasurer and Chief Financial Officer