

CITIZENS & NORTHERN CORP
Form 10-Q
November 07, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011
or

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

For the transition period from _____ to _____.

Commission file number: 000-16084

CITIZENS & NORTHERN CORPORATION

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA
(State or other jurisdiction of
incorporation or organization)

23-2451943
(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 No

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

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

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

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

Yes No

Edgar Filing: CITIZENS & NORTHERN CORP - Form 10-Q

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)

12,138,191 Shares Outstanding on November 3, 2011

CITIZENS & NORTHERN CORPORATION
Index

Part I. Financial Information	
Item 1. Financial Statements	
Consolidated Balance Sheet (Unaudited) – September 30, 2011 and December 31, 2010	Page 3
Consolidated Statement of Operations (Unaudited) - Three Months and Nine Months Ended September 30, 2011 and 2010	Page 4
Consolidated Statement of Cash Flows (Unaudited) - Nine Months Ended September 30, 2011 and 2010	Page 5
Consolidated Statement of Changes in Stockholders' Equity (Unaudited) - Nine Months Ended September 30, 2011 and 2010	Page 6
Notes to Unaudited Consolidated Financial Statements	Pages 7 – 34
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	Pages 35 – 53
Item 3. Quantitative and Qualitative Disclosures About Market Risk	Pages 53 – 56
Item 4. Controls and Procedures	Page 56
Part II. Other Information	Pages 57 – 58
Signatures	Page 59
Exhibit 31.1. Rule 13a-14(a)/15d-14(a) Certification - Chief Executive Officer	Page 60
Exhibit 31.2. Rule 13a-14(a)/15d-14(a) Certification - Chief Financial Officer	Page 61
Exhibit 32. Section 1350 Certifications	Page 62

PART 1 - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEET (Unaudited)

(In Thousands Except Share Data)

September 30, December 31,
2011 2010**ASSETS**

Cash and due from banks:

Noninterest-bearing \$ 20,608 \$ 16,840

Interest-bearing 35,146 29,461

Total cash and cash equivalents 55,754 46,301

Available-for-sale securities, at fair value 472,113 443,956

Loans held for sale 1,218 5,247

Loans receivable 705,879 730,411

Allowance for loan losses (8,177) (9,107)

Loans, net 697,702 721,304

Bank-owned life insurance 20,761 21,822

Accrued interest receivable 5,144 4,960

Bank premises and equipment, net 19,372 22,636

Foreclosed assets held for sale 1,596 537

Deferred tax asset, net 7,927 16,054

Intangible asset - Core deposit intangibles 240 326

Intangible asset - Goodwill 11,942 11,942

Other assets 18,285 21,503

TOTAL ASSETS \$ 1,312,054 \$ 1,316,588**LIABILITIES**

Deposits:

Noninterest-bearing \$ 177,326 \$ 158,767

Interest-bearing 818,404 845,581

Total deposits 995,730 1,004,348

Short-term borrowings 19,234 18,413

Long-term borrowings 128,024 148,495

Accrued interest and other liabilities 7,856 6,388

TOTAL LIABILITIES 1,150,844 1,177,644**STOCKHOLDERS' EQUITY**

Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; no shares issued at September 30, 2011 and December 31, 2010 0 0

Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2011 and 2010; issued 12,447,219 at September 30, 2011 and 12,408,212 at December 31, 2010 12,447 12,408

Paid-in capital 67,322 66,648

Retained earnings 78,085 65,920

Treasury stock, at cost; 306,589 shares at September 30, 2011 and 254,614 shares at December 31, 2010 (5,128) (4,431)

Sub-total 152,726 140,545

Accumulated other comprehensive income (loss):

Unrealized gains (losses) on available-for-sale securities 8,787 (1,351)

Edgar Filing: CITIZENS & NORTHERN CORP - Form 10-Q

Defined benefit plans	(303)	(250)
Total accumulated other comprehensive income (loss)	8,484	(1,601)
TOTAL STOCKHOLDERS' EQUITY	161,210	138,944
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	\$ 1,312,054	\$ 1,316,588

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

Edgar Filing: CITIZENS & NORTHERN CORP - Form 10-Q

CONSOLIDATED STATEMENT OF OPERATIONS (In Thousands, Except Per Share Data) (Unaudited)	3 Months Ended		Fiscal Year To Date	
	Sept. 30, 2011 (Current)	Sept. 30, 2010 (Prior Year)	9 Months Ended 2011 (Current)	Sept. 30, 2010 (Prior Year)
INTEREST INCOME				
Interest and fees on loans	\$10,799	\$11,153	\$32,521	\$33,112
Interest on balances with depository institutions	13	26	45	102
Interest on loans to political subdivisions	372	395	1,119	1,192
Interest on trading securities	0	0	0	1
Income from available-for-sale and held-to-maturity securities:				
Taxable	2,784	2,641	8,326	8,425
Tax-exempt	1,285	1,223	3,860	3,588
Dividends	64	57	187	194
Total interest and dividend income	15,317	15,495	46,058	46,614
INTEREST EXPENSE				
Interest on deposits	1,775	2,916	6,610	9,131
Interest on short-term borrowings	6	15	20	166
Interest on long-term borrowings	1,327	1,708	4,122	5,638
Total interest expense	3,108	4,639	10,752	14,935
Net interest income	12,209	10,856	35,306	31,679
(Credit) provision for loan losses	(37)	189	(198)	472
Net interest income after (credit) provision for loan losses	12,246	10,667	35,504	31,207
OTHER INCOME				
Service charges on deposit accounts	1,230	1,166	3,586	3,449
Service charges and fees	218	191	643	594
Trust and financial management revenue	785	876	2,608	2,605
Interchange revenue from debit card transactions	490	427	1,427	1,226
Net gains from sale of loans	263	275	677	478
Increase in cash surrender value of life insurance	127	121	381	352
Insurance commissions, fees and premiums	66	65	192	186
Impairment loss on limited partnership investment	0	0	(948)	0
Other operating income	820	441	1,661	1,480
Sub-total	3,999	3,562	10,227	10,370
Total other-than-temporary impairment losses on available-for-sale securities	0	0	0	(381)
Portion of (gain) loss recognized in other comprehensive loss (before taxes)	0	0	0	(52)
Net impairment losses recognized in earnings	0	0	0	(433)
Realized gains on available-for-sale securities, net	26	388	2,028	1,198
Net realized gains on available-for-sale securities	26	388	2,028	765
Total other income	4,025	3,950	12,255	11,135
OTHER EXPENSES				
Salaries and wages	3,451	3,354	10,321	9,631
Pensions and other employee benefits	1,020	980	3,344	2,902
Occupancy expense, net	641	654	2,038	2,004
Furniture and equipment expense	498	500	1,435	1,610
FDIC Assessments	174	382	688	1,201
Pennsylvania shares tax	345	305	984	916

Edgar Filing: CITIZENS & NORTHERN CORP - Form 10-Q

Other operating expense	1,923	1,907	5,299	5,518
Total other expenses	8,052	8,082	24,109	23,782
Income before income tax provision	8,219	6,535	23,650	18,560
Income tax provision	2,230	1,671	6,423	4,389
Net income	5,989	4,864	17,227	14,171
U.S Treasury preferred dividends	0	729	0	1,474
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	\$5,989	\$4,135	\$17,227	\$12,697
Net income per share – basic	\$0.49	\$0.34	\$1.42	\$1.05
Net income per share – diluted	\$0.49	\$0.34	\$1.42	\$1.05

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

CONSOLIDATED STATEMENT OF CASH FLOWS (In Thousands) (Unaudited)	Nine Months Ended September 30,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 17,227	\$ 14,171
Adjustments to reconcile net income to net cash provided by operating activities:		
(Credit) provision for loan losses	(198)	472
Realized gains on available-for-sale securities, net	(2,028)	(765)
Gain on sale of foreclosed assets, net	(8)	(113)
Depreciation expense	1,584	1,787
Gain on disposition of premises and equipment	(324)	(442)
Accretion and amortization on securities, net	1,045	1,740
Accretion and amortization on loans, deposits and borrowings, net	(27)	(179)
Amortization of mortgage servicing rights	48	0
Impairment loss on limited partnership interest	948	0
Increase in cash surrender value of life insurance	(381)	(352)
Stock-based compensation	386	50
Amortization of core deposit intangibles	86	132
Deferred income taxes	2,936	6,360
Gains on sales of mortgage loans, net	(677)	(478)
Origination of mortgage loans for sale	(15,166)	(19,228)
Proceeds from sales of mortgage loans	19,683	19,516
Net decrease in trading securities	0	1,045
Decrease in accrued interest receivable and other assets	888	3,543
Increase (decrease) in accrued interest payable and other liabilities	1,280	(238)
Net Cash Provided by Operating Activities	27,302	27,021
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturity of held-to-maturity securities	0	300
Proceeds from sales of available-for-sale securities	16,696	51,528
Proceeds from calls and maturities of available-for-sale securities	79,813	137,313
Purchase of available-for-sale securities	(108,327)	(219,143)
Redemption of Federal Home Loan Bank of Pittsburgh stock	1,164	0
Net decrease (increase) in loans	22,150	(5,615)
Proceeds from bank-owned life insurance	1,442	1,442
Purchase of premises and equipment	(666)	(595)
Proceeds from disposition of premises and equipment	3,060	100
Purchase of investment in limited liability entity	(200)	0
Return of principal on limited liability entity investments	93	49
Proceeds from sale of foreclosed assets	640	1,100
Net Cash Provided by (Used in) Investing Activities	15,865	(33,521)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (decrease) increase in deposits	(8,632)	56,711
Net increase (decrease) in short-term borrowings	821	(20,827)
Repayments of long-term borrowings	(20,471)	(37,453)
Redemption of US Treasury preferred stock and warrant	0	(26,840)
Purchase of treasury stock	(983)	0
Sale of treasury stock	16	0
Tax benefit from compensation plans	48	29
US Treasury preferred dividends paid	0	(952)
Common dividends paid	(4,513)	(3,008)

Edgar Filing: CITIZENS & NORTHERN CORP - Form 10-Q

Net Cash Used in Financing Activities	(33,714)	(32,340)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	9,453	(38,840)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	46,301	92,065
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 55,754	\$ 53,225
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Assets acquired through foreclosure of real estate loans	\$ 1,691	\$ 644
Interest paid	\$ 10,817	\$ 15,280
Income taxes paid (refunded)	\$ 2,300	\$ (3,781)

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

Consolidated Statement of Changes in Stockholders' Equity

Nine Months Ended September 30, 2011 and 2010

(In Thousands Except Per Share Data)

(Unaudited)	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Accum. Other Comprehensive Income (Loss)	Treasury Stock	Total
Nine Months Ended September 30, 2011:							
Balance, December 31, 2010	\$ 0	\$ 12,408	\$ 66,648	\$ 65,920	\$ (1,601)	\$ (4,431)	\$ 138,944
Comprehensive income:							
Net income				17,227			17,227
Unrealized gain on securities, net of reclassification and tax					10,138		10,138
Other comprehensive loss related to defined benefit plans					(53)		(53)
Total comprehensive income							27,312
Cash dividends declared on common stock, \$.42 per share				(5,110)			(5,110)
Shares issued for dividend reinvestment plan		39	558				597
Treasury stock purchased						(983)	(983)
Shares issued from treasury related to exercise of stock options			(3)			19	16
Restricted stock granted			(272)			272	0
Forfeiture of restricted stock			5			(5)	0
Stock-based compensation expense			386				386
Tax benefit from employee benefit plan				48			48
Balance, September 30, 2011	\$ 0	\$ 12,447	\$ 67,322	\$ 78,085	\$ 8,484	\$ (5,128)	\$ 161,210
Nine Months Ended September 30, 2010:							
	\$ 25,749	\$ 12,374	\$ 66,726	\$ 53,027	\$ (891)	\$ (4,575)	\$ 152,410

Balance, December 31, 2009							
Comprehensive income:							
Net income			14,171				14,171
Unrealized gain on securities, net of reclassification and tax				4,915			4,915
Other comprehensive income related to defined benefit plans				138			138
Total comprehensive income							19,224
Accretion of discount associated with U.S. Treasury preferred stock	691		(691)				0
Cash dividends on U.S. Treasury preferred stock			(783)				(783)
Redemption of U.S. Treasury preferred stock	(26,440)						(26,440)
Redemption of U.S. Treasury warrant			(400)				(400)
Cash dividends declared on common stock, \$.27 per share			(3,273)				(3,273)
Shares issued for dividend reinvestment plan	23	242					265
Restricted stock granted			(159)		159		0
Forfeiture of restricted stock			15		(15)		0
Stock-based compensation expense			50				50
Tax benefit from employee benefit plan				29			29
Balance, September 30, 2010	\$ 0	\$ 12,397	\$ 66,474	\$ 62,480	\$ 4,162	\$ (4,431)	\$ 141,082

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

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

2. PER COMMON SHARE DATA

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

	Net Income Available to Common Shareholders	Weighted- Average Common Shares	Earnings Per Share
Nine Months Ended September 30, 2011			
Earnings per common share – basic	\$ 17,227,000	12,167,563	\$ 1.42
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		92,786	
Hypothetical share repurchase at \$15.57		(89,738)	
Earnings per common share – diluted	\$ 17,227,000	12,170,611	\$ 1.42
Nine Months Ended September 30, 2010			
Earnings per common share – basic and diluted	\$ 12,697,000	12,125,142	\$ 1.05
Quarter Ended September 30, 2011			
Earnings per common share – basic	\$ 5,989,000	12,150,910	\$ 0.49
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		91,843	
Hypothetical share repurchase at \$15.56		(88,892)	
Earnings per common share – diluted	\$ 5,989,000	12,153,861	\$ 0.49
Quarter Ended September 30, 2010			
Earnings per common share – basic and diluted	\$ 4,135,000	12,136,516	\$ 0.34

Stock options and a warrant that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 224,651 shares in the nine-month period ended September 30, 2011, 424,179 shares in the nine months ended September 30, 2010, 223,463 shares in the third quarter 2011 and 362,738 shares in the third quarter 2010. All instruments for 2010 were anti-dilutive.

3. COMPREHENSIVE INCOME

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

(In Thousands)	3 Months Ended September 30,		9 Months Ended September 30,	
	2011	2010	2011	2010
Net income	\$5,989	\$4,864	\$17,227	\$14,171
Unrealized gains on available-for-sale securities:				
Unrealized holding gains on available-for-sale securities	5,310	4,467	17,384	8,191
Reclassification adjustment for gains realized in income	(26)	(388)	(2,028)	(765)
Other comprehensive gain before income tax	5,284	4,079	15,356	7,426
Income tax related to other comprehensive gain	1,796	1,370	5,218	2,511
Other comprehensive gain on available-for-sale securities	3,488	2,709	10,138	4,915
Unfunded pension and postretirement obligations:				
Change in items from defined benefit plans included in accumulated other comprehensive income	0	16	(122)	168
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	14	13	41	40
Other comprehensive gain (loss) before income tax	14	29	(81)	208
Income tax related to other comprehensive gain (loss)	4	9	(28)	70
Other comprehensive gain (loss) on unfunded retirement obligations	10	20	(53)	138
Net other comprehensive gain	3,498	2,729	10,085	5,053
Total comprehensive income	\$9,487	\$7,593	\$27,312	\$19,224

The Corporation recognized other comprehensive income of \$52,000 before income tax (\$34,000 after income tax) related to available-for-sale debt securities for which a portion of an other-than-temporary impairment (OTTI) loss has been recognized in earnings in the nine months ended September 30, 2010, with no other comprehensive income in the third quarter 2010.

4. FAIR VALUE MEASUREMENTS AND FAIR VALUES OF FINANCIAL INSTRUMENTS

The Corporation measures certain assets at fair value on a recurring basis. Fair value is defined as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. FASB ASC topic 820, "Fair Value Measurements and Disclosures" (formerly Statement of Financial Accounting Standards No. 157) establishes a framework for measuring fair value that includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The levels of the fair value hierarchy are as follows:

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

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

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

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

(In Thousands)	Quoted Prices in Active Markets (Level 1)	September 30, 2011 Market Values Based on:		Total Fair Value
		Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of U.S. Government agencies	\$ 0	\$34,250	\$ 0	\$34,250
Obligations of states and political subdivisions:				
Tax-exempt	0	132,545	0	132,545
Taxable	0	13,354	0	13,354
Mortgage-backed securities	0	121,967	0	121,967
Collateralized mortgage obligations, Issued by U.S.				
Government agencies	0	146,002	0	146,002
Corporate bonds	0	1,001	0	1,001
Trust preferred securities issued by individual institutions	0	8,181	0	8,181
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	0	0	7,103	7,103
Other collateralized debt obligations	0	660	0	660
Total debt securities	0	457,960	7,103	465,063
Marketable equity securities	7,050	0	0	7,050
Total available-for-sale securities	7,050	457,960	7,103	472,113
Servicing rights	0	0	346	346

Total assets measured at fair value on a recurring basis	\$ 7,050	\$457,960	\$ 7,449	\$472,459
--	----------	-----------	----------	-----------

9

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

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

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

Management has calculated the fair value of the Corporation's senior tranche pooled trust-preferred security by applying a discount rate to the estimated cash flows. In 2011, management's estimate of cash flows from the senior tranche security changed significantly from the estimates in previous years based on the level and timing of assumed prepayments that changed for some of the underlying issuers. Management used the cash flow estimates determined using the process described in Note 5 for evaluating pooled trust-preferred securities for other-than-temporary impairment (OTTI). Management used a discount rate considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the security. In establishing the discount rate, management considered: (1) the implied discount rate as of the end of 2007, prior to the market for trust-preferred securities becoming inactive; (2) adjustment to the year-end 2007 discount rate for the change in the spread between indicative

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

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

	3 Months Ended		Fiscal Year To Date	
	Sept. 30, 2011 (Current)	Sept. 30, 2010 (Prior Year)	9 Months Ended 2011 (Current)	Sept. 30, 2010 (Prior Year)
Balance, beginning of period	\$ 7,207	\$ 8,240	\$ 7,400	\$ 9,114
Accretion and amortization, net	0	(20)	(34)	(235)
Proceeds from sales and calls	(24)	(284)	(2,109)	(808)
Realized gains, net	24	284	99	284
Unrealized losses included in earnings	0	0	0	(423)
Unrealized (losses) gains included in other comprehensive income	(104)	20	1,747	308
Balance, end of period	\$ 7,103	\$ 8,240	\$ 7,103	\$ 8,240

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

Assets measured at fair value on a nonrecurring basis include impaired commercial loans and foreclosed real estate assets held for sale. All of the Corporation's impaired commercial loans for which a valuation allowance was necessary at September 30, 2011 and December 31, 2010 were valued based on the estimated amount of net proceeds from liquidation of real estate and other collateral, or based on the estimated present value of cash flows to be received. The Corporation considers the fair value of such impaired commercial loans to be based on unobservable inputs (Level 3), and the balance of impaired loans for which a valuation allowance was recorded, net of allowance for loan losses, was \$2,415,000 at September 30, 2011 and \$3,169,000 at December 31, 2010. Similarly, the carrying values of foreclosed real estate assets held for sale were based on unobservable inputs (Level 3), with a balance of \$1,596,000 at September 30, 2011 and \$537,000 at December 31, 2010.

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

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

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

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

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

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

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 life of the underlying loans.

DEPOSITS - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable on demand at September 30, 2011 and December 31, 2010. The fair value of all other deposit categories is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates of deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

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

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

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

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

(In Thousands)	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	\$ 55,754	\$ 55,754	\$ 46,301	\$ 46,301
Available-for-sale securities	472,113	472,113	443,956	443,956
Restricted equity securities	7,123	7,123	8,286	8,286
Loans held for sale	1,218	1,218	5,247	5,249
Loans, net	697,702	703,299	721,304	728,744
Accrued interest receivable	5,144	5,144	4,960	4,960
Servicing rights	346	346	204	204
Financial liabilities:				
Deposits	995,730	1,000,179	1,004,348	1,012,247
Short-term borrowings	19,234	18,965	18,413	18,240
Long-term borrowings	128,024	147,369	148,495	171,877
Accrued interest payable	351	351	430	430

5. SECURITIES

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

(In Thousands)	Amortized Cost	September 30, 2011		Fair Value
		Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
Obligations of U.S. Government agencies	\$33,459	\$791	\$0	\$34,250
Obligations of states and political subdivisions:				
Tax-exempt	130,537	3,782	(1,774)	132,545
Taxable	13,080	282	(8)	13,354
Mortgage-backed securities	116,314	5,653	0	121,967
Collateralized mortgage obligations, Issued by U.S.				
Government agencies	143,275	2,774	(47)	146,002
Corporate bonds	1,000	1	0	1,001
Trust preferred securities issued by individual institutions	7,015	1,211	(45)	8,181
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	7,914	0	(811)	7,103
Other collateralized debt obligations	660	0	0	660
Total debt securities	453,254	14,494	(2,685)	465,063
Marketable equity securities	5,548	1,698	(196)	7,050
Total	\$458,802	\$16,192	\$(2,881)	\$472,113
		December 31, 2010		
		Gross	Gross	