CITIZENS & NORTHERN CORP
Form 10-Q
November 07, 2008

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

o **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 þ No o

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

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)	8,964,262 Shares Outstanding on October 31, 2008

CITIZENS & NORTHERN CORPORATION FORM 10-Q

CITIZENS & NORTHERN CORPORATION

Index

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
PART I FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
Consolidated Balance Sheet

(In Thousands Except Share Data)	September 30, 2008 (Unaudited)	December 31, 2007 (Note)
ASSETS		
Cash and due from banks:		
Noninterest-bearing	$ 21,777	$ 21,892
Interest-bearing	1,383	9,769
Total cash and cash equivalents	23,160	31,661
Trading securities	1,630	2,980
Available-for-sale securities	417,761	432,755
Held-to-maturity securities	407	409
Loans, net	748,909	727,082
Bank-owned life insurance	22,119	21,539
Accrued interest receivable	5,846	5,714
Bank premises and equipment, net	26,500	27,796
Foreclosed assets held for sale	312	258
Intangible asset Core deposit intangibles	964	1,378
Intangible asset Goodwill	12,014	12,032
Other assets	29,275	20,142
TOTAL ASSETS	$1,288,897	$1,283,746
LIABILITIES		
Deposits:		
Noninterest-bearing	$ 126,649	$ 125,485
Interest-bearing	729,927	713,018
Total deposits	856,576	838,503
Dividends payable	2,149	2,134
Short-term borrowings	52,650	40,678
Long-term borrowings	249,395	259,454
Accrued interest and other liabilities	6,053	5,196
TOTAL LIABILITIES	1,166,823	1,145,965
STOCKHOLDERS EQUITY		
Common stock, par value $1.00 per share; authorized 20,000,000 shares in 2008 and 2007; issued 9,284,148 in 2008 and 9,193,192 in 2007	9,284	9,193
Stock dividend distributable		1,571
Paid-in capital	44,215	42,494
Retained earnings	97,723	96,628

Unamortized stock compensation	(71)	(56)
Treasury stock, at cost; 338,730 shares at September 30, 2008 and 303,058 shares at December 31, 2007	(5,815)	(4,992)
Sub-total	145,336	144,838
Accumulated other comprehensive loss:		
Unrealized losses on available-for-sale securities	(23,149)	(6,654)
Defined benefit plans	(113)	(403)
Total accumulated other comprehensive loss	(23,262)	(7,057)
TOTAL STOCKHOLDERS EQUITY	122,074	137,781
TOTAL LIABILITIES & STOCKHOLDERS EQUITY	$1,288,897	$1,283,746

The accompanying notes are an integral part of these consolidated financial statements.
Note: The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date but does not include all the information and notes required by U.S. generally accepted accounting principles for complete financial statements.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
Consolidated Statement of Income

(In Thousands, Except Per Share Data) (Unaudited)	3 Months Ended Sept. 30, 2008 (Current)	3 Months Ended Sept. 30, 2007 (Prior Year)	Fiscal Year To Date 9 Months Ended Sept. 30, 2008 (Current)	Fiscal Year To Date 9 Months Ended Sept. 30, 2007 (Prior Year)
INTEREST INCOME				
Interest and fees on loans	$ 12,255	$ 12,929	$ 36,836	$ 36,889
Interest on loans to political subdivisions	406	369	1,116	1,072
Interest on balances with depository institutions	9	16	27	74
Interest on federal funds sold	42	50	116	200
Interest on trading securities	19	27	62	46
Income from available-for-sale and held-to-maturity securities:				
Taxable	4,815	3,777	14,574	10,945
Tax-exempt	828	677	2,267	2,076
Dividends	201	213	650	691
Total interest and dividend income	18,575	18,058	55,648	51,993
INTEREST EXPENSE				
Interest on deposits	4,557	6,437	14,941	18,780
Interest on short-term borrowings	218	432	761	1,397
Interest on long-term borrowings	2,699	1,682	8,152	5,053
Total interest expense	7,474	8,551	23,854	25,230
Interest margin	11,101	9,507	31,794	26,763
Provision for loan losses	141		669	229
Interest margin after provision for loan losses	10,960	9,507	31,125	26,534
OTHER INCOME				
Trust and financial management revenue	845	885	2,697	2,506
Service charges on deposit accounts	1,191	709	3,240	1,824
Service charges and fees	208	177	569	501
Insurance commissions, fees and premiums	77	108	246	368
Increase in cash surrender value of life insurance	190	196	580	515
Other operating income	551	802	2,372	1,895
Total other income before net losses on available-for-sale securities	3,062	2,877	9,704	7,609
Net losses on available-for-sale securities	(4,483)	(68)	(5,460)	(79)
Total other income	(1,421)	2,809	4,244	7,530

OTHER EXPENSES				
Salaries and wages	3,892	3,741	11,319	10,769
Pensions and other employee benefits	1,082	1,032	3,312	3,190
Occupancy expense, net	689	668	2,160	1,954
Furniture and equipment expense	692	708	1,982	2,104
Pennsylvania shares tax	292	236	876	707
Other operating expense	2,089	2,306	5,808	6,403
Total other expenses	8,736	8,691	25,457	25,127
Income before income tax provision	803	3,625	9,912	8,937
Income tax (credit) provision	(209)	777	2,031	1,695
NET INCOME	$ 1,012	$ 2,848	$ 7,881	$ 7,242
PER SHARE DATA:				
Net income basic	$ 0.11	$ 0.32	$ 0.88	$ 0.83
Net income diluted	$ 0.11	$ 0.32	$ 0.88	$ 0.83
Dividend per share	$ 0.24	$ 0.24	$ 0.72	$ 0.72
Number of shares used in computation basic	8,957,774	8,986,822	8,965,230	8,743,490
Number of shares used in computation diluted	8,986,253	8,994,805	8,985,211	8,756,013

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

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
Consolidated Statement of Cash Flows

(In Thousands) (Unaudited)	9 Months Ended Sept. 30, 2008	9 Months Ended Sept. 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 7,881	$ 7,242
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	669	229
Net losses on available-for-sale securities	5,460	79
Gain on sale of foreclosed assets, net	(46)	(76)
Loss on disposition of premises and equipment		145
Depreciation expense	2,174	2,125
Accretion and amortization on securities, net	136	274
Accretion and amortization on loans, deposits and borrowings, net	(314)	(158)
Increase in cash surrender value of life insurance	(580)	(515)
Stock-based compensation	274	231
Amortization of core deposit intangibles	414	289
Net increase in trading securities	(1,722)	(2,515)
Increase in accrued interest receivable and other assets	(1,708)	(1,099)
Increase in accrued interest payable and other liabilities	1,067	482
Net Cash Provided by Operating Activities	13,705	6,733
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from acquisition of Citizens Bancorp, Inc., net		29,941
Proceeds from maturity of held-to-maturity securities	2	4
Proceeds from sales of available-for-sale securities	22,682	91,088
Proceeds from calls and maturities of available-for-sale securities	44,525	27,235
Purchase of available-for-sale securities	(79,737)	(85,847)
Purchase of Federal Home Loan Bank of Pittsburgh stock	(2,629)	(4,655)
Redemption of Federal Home Loan Bank of Pittsburgh stock	3,299	4,977
Net (increase) decrease in loans	(22,706)	1,483
Purchase of premises and equipment	(878)	(2,157)
Return of principal on limited partnership investment	34	238
Proceeds from sale of foreclosed assets	374	478
Net Cash (Used in) Provided by Investing Activities	(35,034)	62,785
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	18,045	(32,615)
Net increase (decrease) in short-term borrowings	11,972	(2,805)
Proceeds from long-term borrowings	29,703	42,500
Repayments of long-term borrowings	(39,592)	(74,927)
Purchase of treasury stock	(1,567)	(950)
Sale of treasury stock	154	88
Dividends paid	(5,887)	(6,115)

Net Cash Provided by (Used in) Financing Activities	12,828	(74,824)
DECREASE IN CASH AND CASH EQUIVALENTS	(8,501)	(5,306)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	31,661	27,159
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 23,160	$ 21,853

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

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
Consolidated Statement of Cash Flows

(In Thousands) (Unaudited) (Continued)	9 Months Ended Sept. 30, 2008	Sept. 30, 2007
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Assets acquired through foreclosure of real estate loans	$ 382	$ 417
Securities transferred from trading to available-for-sale	3,072	
Interest paid	24,097	25,278
Income taxes paid	3,492	1,977
ACQUISITION OF CITIZENS BANCORP, INC.:		
Cash and cash equivalents received		44,264
Cash paid for acquisition		(14,323)
Net cash received on acquisition	$	$ 29,941
NONCASH ASSETS RECEIVED, LIABILITIES ASSUMED AND EQUITY ISSUED FROM ACQUISITION OF CITIZENS BANCORP, INC.:		
Assets received:		
Available for sale securities	$	$ 26,426
Loans		60,151
Bank-owned life insurance		4,433
Premises and equipment		5,243
Foreclosed assets		107
Intangible asset core deposit intangible		1,487
Intangible asset goodwill		9,263
Other assets		1,567
Total noncash assets received	$	$ 108,677
Liabilities assumed and equity issued:		
Deposits	$	$ 99,636
Short-term borrowings		1,426
Long-term borrowings		22,753
Other liabilities		735
Equity issued, net		14,068
Total noncash liabilities assumed and equity issued	$	$ 138,618

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

CITIZENS & NORTHERN CORPORATION FORM 10-Q
Notes to Consolidated Financial Statements

1. BASIS OF INTERIM PRESENTATION

The financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2007, is unaudited; however, 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 and cash flows for the interim periods.

Results reported for the three-month and nine-month periods ended September 30, 2008 might not be indicative of the results for the year ending December 31, 2008.

This document has not been reviewed or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation or any other regulatory agency.

2. PER SHARE DATA

Net income per share is based on the weighted-average number of shares of common stock outstanding. The number of shares used in calculating net income and cash dividends per share reflects the retroactive effect of stock dividends for all periods presented. The following data shows the amounts used in computing net income per share and the weighted average number of shares of dilutive stock options. 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
Nine Months Ended September 30, 2008			
Earnings per share basic	$7,881,000	8,965,230	$0.88
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		145,729	
Hypothetical share repurchase at $19.88		(125,748)	
Earnings per share diluted	$7,881,000	8,985,211	$0.88
Nine Months Ended September 30, 2007			
Earnings per share basic	$7,242,000	8,743,490	$0.83
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		109,329	
Hypothetical share repurchase at $20.50		(96,806)	
Earnings per share diluted	$7,242,000	8,756,013	$0.83

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

	Net Income	Weighted-Average Common Shares	Earnings Per Share
Quarter Ended September 30, 2008			
Earnings per share basic	$1,012,000	8,957,774	$0.11
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		174,332	
Hypothetical share repurchase at $21.41		(145,853)	
Earnings per share diluted	$1,012,000	8,986,253	$0.11
Quarter Ended September 30, 2007			
Earnings per share basic	$2,848,000	8,986,822	$0.32
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		108,115	
Hypothetical share repurchase at $18.93		(100,132)	
Earnings per share diluted	$2,848,000	8,994,805	$0.32

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 (loss) income, and the related tax effects, are as follows:

	3 Months Ended Sept. 30,		9 Months Ended Sept. 30,	
(In Thousands)	**2008**	**2007**	**2008**	**2007**
Net income	$ 1,012	$ 2,848	$ 7,881	$ 7,242
Unrealized (losses) gains on available-for-sale securities:				
Unrealized holding (losses) gains on available-for-sale securities	(15,623)	(2,333)	(30,452)	(6,026)
Reclassification adjustment for losses realized in income	4,483	68	5,460	79
Other comprehensive loss on available-for-sale securities before income tax	(11,140)	(2,265)	(24,992)	(5,947)
Income tax related to unrealized loss on available-for-sale securities	3,788	770	8,497	2,022

Other comprehensive loss on available-for-sale securities	(7,352)	(1,495)	(16,495)	(3,925)
Unfunded pension and postretirement obligations:				
Amortization of net transition obligation, prior service cost, net actuarial loss and gain from settlement of pension plan included in net periodic benefit cost, and additional reduction in unfunded liability from settlement of pension plan	444	11	455	33
Income tax related to other comprehensive gain	(164)	(3)	(165)	(12)
Other comprehensive gain on unfunded retirement obligations	280	8	290	21
Total comprehensive (loss) income	$ (6,060)	$ 1,361	$ (8,324)	$ 3,338

8

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

4. SECURITIES

The Corporation s trading assets at September 30, 2008 and December 31, 2007 were composed exclusively of municipal bonds. Gains and losses from trading activities are included in other operating income in the consolidated statement of income as follows (in thousands):

	3 Months Ended		Fiscal Year To Date 9 Months Ended Sept. 30,	
	Sept. 30, 2008	Sept. 30, 2007	2008	2007
Gross realized gains	$ 20	$46	$ 60	$ 52
Gross realized losses			(63)	
Net change in unrealized gains/losses	(140)	1	(141)	(76)
Net (losses) gains	$(120)	$47	$(144)	$(24)
Income tax (credit) provision related to net losses	$ (41)	$16	$ (49)	$ (8)

Amortized cost and fair value of available-for-sale and held-to-maturity securities at September 30, 2008 are summarized as follows:

	September 30, 2008			
(In Thousands)	**Amortized Cost**	**Gross Unrealized Holding Gains**	**Gross Unrealized Holding Losses**	**Fair Value**
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of other U.S. Government agencies	$ 15,500	$ 243	$	$ 15,743
Obligations of states and political subdivisions	75,925	113	(6,781)	69,257
Mortgage-backed securities	170,978	506	(1,418)	170,066
Collateralized mortgage obligations	70,449	5	(3,758)	66,696
Other securities	98,780	102	(24,740)	74,142
Total debt securities	431,632	969	(36,697)	395,904
Marketable equity securities	21,209	2,948	(2,300)	21,857
Total	$452,841	$3,917	$(38,997)	$417,761
HELD-TO-MATURITY SECURITIES:				
Obligations of the U.S. Treasury	$ 305	$ 14	$	$ 319
Obligations of other U.S. Government agencies	100	4		104
Mortgage-backed securities	2			2
Total	$ 407	$ 18	$	$ 425

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

The following table presents gross unrealized losses and fair value of available-for-sale investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2008:

September 30, 2008

	Less Than 12 Months		12 Months or More		Total	
(In Thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
AVAILABLE-FOR-SALE SECURITIES:						
Obligations of other U.S. Government agencies	$	$	$	$	$	$
Obligations of states and political subdivisions	32,939	(2,834)	24,598	(3,947)	57,537	(6,781)
Mortgage-backed securities	112,319	(1,282)	7,280	(136)	119,599	(1,418)
Collateralized mortgage obligations	47,665	(1,956)	17,985	(1,802)	65,650	(3,758)
Other securities	32,058	(11,280)	35,021	(13,460)	67,079	(24,740)
Total debt securities	224,981	(17,352)	84,884	(19,345)	309,865	(36,697)
Marketable equity securities	3,587	(663)	5,838	(1,637)	9,425	(2,300)
Total temporarily impaired available-for-sale securities	$228,568	$(18,015)	$90,722	$(20,982)	$319,290	$(38,997)

Management evaluates securities for other-than-temporary impairment 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) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

In addition to the effects of volatility in interest rates on individual debt securities, management believes valuations of debt securities at September 30, 2008 have been negatively impacted by events affecting the overall credit markets during the last quarter of 2007 and the first nine months of 2008. There have been widespread disruptions to the normal operation of bond markets. Particularly with regard to trust-preferred securities (which comprise most of the balance in Other securities in the table above), trading volume has been limited and consisted almost entirely of sales by distressed sellers.

Trust-preferred securities are very long-term (usually 30-year maturity) instruments with characteristics of both debt and equity, mainly issued by banks. Most of the Corporation s investments in trust-preferred securities are of pooled issues, each made up of 30 or more companies with geographic and size diversification. Almost all of the Corporation s pooled trust-preferred securities are comprised of debt issued by banking companies, with lesser amounts issued by insurance companies and real estate investment trusts. Management believes trust-preferred valuations have been negatively affected by concerns that the underlying banks and other companies may have significant exposure to losses from sub-prime mortgages, defaulted collateralized debt obligations or other concerns. Several of the Corporation s trust-preferred securities were downgraded by Moody s during the third quarter 2008, with five securities falling to ratings of less than investment grade. Further, Moody s and Fitch have placed all of the pooled trust-preferred securities on Ratings Watch Negative, meaning that an initial or further downgrade may be possible in the foreseeable future. In the first nine months of 2008, some of the issuers of trust-preferred securities that are included in the Corporation s pooled investments have elected to defer payment of interest on these obligations (trust-preferred securities typically permit deferral of quarterly interest payments for up to five years), and some issuers have defaulted. Trust-preferred securities are structured so that the issuers pay more interest into the trusts than would be required for pass through to the investors in the rated notes (such as the Corporation), with the excess used to cover administrative and other expenses, and to provide a cushion for some protection against the risk of loss for investors in the rated notes.

As of September 30, 2008, management evaluated the pooled trust-preferred securities for other-than-temporary impairment by estimating the cash flows a market participant would expect to receive from each security, taking into account estimated levels of deferrals and defaults by the underlying issuers. In determining cash flows, management assumed all issuers currently deferring or in default would make no future payments, and assigned estimated future default levels for the remaining issuers in each security based on financial strength ratings assigned by a national ratings service. Management calculated the present value of each security based on the current book yield, adjusted for future changes in 3-month LIBOR (which is the index rate on the Corporation s adjustable rate pooled trust-

preferred securities) based on the applicable forward curve. For most of the pooled trust-preferred securities, the present value determined on that basis had not declined from management s previous assumptions used to determine book value, and accordingly, impairment was deemed temporary. However, for three of the securities, the present values declined, and the Corporation wrote the historical cost basis down to estimated fair value, resulting in other-than-temporary impairment charges totaling $4,289,000 (pretax). Management s estimates of cash flows used to evaluate other-than-temporary impairment of pooled trust-preferred securities were based on sensitive assumptions, and market participants might use substantially different assumptions, which could produce different conclusions for each security. Management s calculations of fair values of pooled trust-preferred securities are described in Note 5.
Based on the Corporation s ability and intent to hold its debt securities for the foreseeable future, and management s assessment of the creditworthiness of the issuers, management believes impairment of the Corporation s debt securities at September 30, 2008, after adjustment for the write-downs of pooled trust-preferred securities described above, to be temporary.

Unrealized losses on marketable equity securities are mainly from investments in common stocks of banking corporations. Management evaluated equity securities held as of September 30, 2008. Upon evaluation, it was determined that equity securities issued by five banking corporations were other-than-temporarily impaired, including one security that management deemed worthless. Management s assessment that these securities were other-than-temporarily impaired was based on a large amount of unrealized loss, poor and rapidly deteriorating financial conditions reflected in published financial reports for each entity, and in some cases, publicly announced endeavors to issue additional shares of stock that would dilute the Corporation s ownership interest. These securities were written down to current fair value at September 30, 2008, and the Corporation recognized a pretax loss in the third quarter 2008 of $458,000, including $24,000 from writing down the worthless security. For the nine months ended September 30, 2008, pretax other-than-temporary impairment losses on bank stocks totaled $1,878,000, including losses totaling $216,000 from the worthless security. As of September 30, 2008, management believes the impairment of the Corporation s other marketable equity securities to be temporary.

5. ASSETS MEASURED AT FAIR VALUE ON A RECURRING BASIS

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. 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.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

At September 30, 2008, assets measured at fair value on a recurring basis and the valuation methods used are as follows:

	September 30, 2008 Market Values Based on:			
(In Thousands)	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 other U.S. Government agencies	$	$ 15,743	$	$ 15,743
Obligations of states and political subdivisions	2,026	67,231		69,257
Mortgage-backed securities	10,065	160,001		170,066
Collateralized mortgage obligations		66,696		66,696
Other securities		10,898	63,244	74,142
Total debt securities	12,091	320,569	63,244	395,904
Marketable equity securities	21,857			21,857
Total available-for-sale securities	33,948	320,569	63,244	417,761
TRADING SECURITIES,				
Obligations of states and political subdivisions		1,630		1,630
Total	$33,948	$322,199	$63,244	$419,391

Management determined there were virtually no trades of pooled trust-preferred securities in the third quarter 2008, except for a limited number of transactions that took 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, at September 30, 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.

At September 30, 2008, management calculated the fair values of pooled trust-preferred securities by applying discount rates to estimated cash flows for each security. Management used the cash flow estimates for each security determined using the process described in Note 4. 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 rates, 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 (3-month LIBOR, for most of the Corporation s securities) over corresponding risk-free rates (3-month U.S. Treasury Bill, for most of the Corporation s securities) as of September 30, 2008; 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 estimates of cash flows and discount rates used to calculate fair values of pooled trust-preferred securities were based on sensitive assumptions, and market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amounts calculated by management.

12

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

Following is a reconciliation of activity for assets (pooled trust-preferred securities) measured at fair value based on significant unobservable information:

(In Thousands)	3 Months Ended Sept. 30, 2008	3 Months Ended Sept. 30, 2007	Fiscal Year To Date 9 Mos. Ended Sept. 30, 2008	Fiscal Year To Date 9 Mos. Ended Sept. 30, 2007
Balance, beginning of period	$	$	$	$
Transfers	73,018		73,018	
Purchases, issuances and settlements	13		13	
Unrealized (losses) included in earnings	(4,289)		(4,289)	
Unrealized (losses) included in other comprehensive income	(5,498)		(5,498)	
Balance, end of period	$63,244	$	$63,244	$

Losses included in earnings are from the September 30, 2008 other-than-temporary impairment analysis of securities, as described in Note 4, and are included in net losses on available-for-sale securities in the consolidated statement of income.

6. 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 affect the liability balance at September 30, 2008 and December 31, 2007, and will not affect the Corporation s future expenses. The Corporation uses a December 31 measurement date for the postretirement plan.

The Corporation s defined benefit pension plan was frozen and terminated, effective December 31, 2007. In the third quarter 2008, the Corporation funded and settled substantially all of its obligations under the Plan. The following table reconciles the funding status of the defined benefit pension plan for the nine months ended September 30, 2008:

(In Thousands)	
CHANGE IN BENEFIT OBLIGATION:	
Benefit obligation at beginning of year	$ 12,035
Service cost	29
Interest cost	446
Actuarial (gain)	(496)
Benefits paid	(495)
Funding and settlement of plan obligations	(11,519)
Benefit obligation at September 30, 2008	$
CHANGE IN PLAN ASSETS:	
Fair value of plan assets at beginning of year	$ 11,428
Actual return on plan assets	243
Employer contribution	343
Plan participants contributions	
Benefits paid	(495)

Funding and settlement of plan obligations		(11,519)
Fair value of plan assets at September 30, 2008	$	
Funded status at September 30, 2008	$	

13

CITIZENS & NORTHERN CORPORATION FORM 10-Q

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

	Pension Nine Months Ended Sept. 30,		Postretirement Nine Months Ended Sept. 30,	
(In Thousands)	**2008**	**2007**	**2008**	**2007**
Service cost	$ 29	$ 512	$ 52	$ 55
Interest cost	446	525	59	52
Expected return on plan assets	(230)	(689)		
Amortization of transition (asset) obligation	(17)	(17)	27	27
Amortization of prior service cost		6	7	
Recognized net actuarial loss		34		2
Net periodic benefit cost, excluding pension plan settlement	228	371	145	136
(Gain) on pension plan settlement	(71)			
Total net periodic benefit cost	$ 157	$ 371	$145	$136

	Pension Three Months Ended Sept. 30,		Postretirement Three Months Ended Sept. 30,	
(In Thousands)	**2008**	**2007**	**2008**	**2007**
Service cost	$ 9	$ 170	$17	$18
Interest cost	148	175	20	17
Expected return on plan assets	(77)	(230)		
Amortization of transition (asset) obligation	(5)	(5)	9	9
Amortization of prior service cost		2	2	
Recognized net actuarial loss		11		1
Net periodic benefit cost, excluding pension plan settlement	75	123	48	45
(Gain) on pension plan settlement	(71)			
Total net periodic benefit cost	$ 4	$ 123	$48	$45

In the first nine months of 2008, the Corporation funded postretirement contributions totaling $44,000, with estimated annual postretirement contributions of $59,000 expected in 2008 for the full year.

7. STOCK-BASED COMPENSATION PLANS

In January 2008, the Corporation granted options to purchase a total of 83,257 shares of common stock through its Stock Incentive and Independent Directors Stock Incentive Plans. In January 2007, the Corporation granted options to purchase a total of 43,385 shares of common stock. The exercise price for the 2008 awards is $17.50 per share, and the exercise price for the 2007 awards is $22.325 per share, based on the market price as of the date of each grant. The Corporation records stock option expense based on estimated fair value calculated using an option valuation model.

CITIZENS & NORTHERN CORPORATION FORM 10-Q

In calculating the fair value, the Corporation utilized the Black-Scholes option-pricing model. The calculated fair value of each option granted, and significant assumptions used in the calculations, are as follows:

	2008	2007
Fair value of each option granted	$3.15	$4.46
Volatility	23%	23%
Expected option lives	9 Years	8 Years
Risk-free interest rate	4.05%	4.69%
Dividend yield	3.74%	3.61%

In calculating the estimated fair value of 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 9-year expected option life used for 2008 awards, and 8-year expected option life used for 2007 awards, was based on management s estimates of the average term for all options issued under both plans. For the 2008 and 2007 awards, management assumed a 23% 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.

Also, the Corporation awarded a total of 5,062 shares in January 2008 and 6,529 shares in January 2007 of restricted stock under the Stock Incentive and Independent Directors Stock Incentive Plans. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period.

Total stock-based compensation expense is as follows:

	3 Months Ended		Fiscal Year To Date 9 Months Ended Sept. 30,	
(In Thousands)	Sept. 30, 2008	Sept. 30, 2007	2008	2007
Stock options	$	$	$209	$156
Restricted stock	18		65	75
Total	$18	$	$274	$231

Stock option expense has been recognized over the six-month vesting period for both the 2008 and 2007 awards.

8. 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.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

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

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

Certain statements in this section and elsewhere in this quarterly report on Form 10-Q are forward-looking statements. Citizens & Northern Corporation and its wholly-owned subsidiaries (collectively, the Corporation) intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Reform Act of 1995. Forward-looking statements, which are not historical facts, are based on certain assumptions and describe future plans, business objectives and expectations, and are generally identifiable by the use of words such as, should , likely , expect , plan , anticipate , target , forecast , and goal . These forwa 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 management s assessment regarding the realization of future cash flows on securities, as well as the determination of whether securities are other-than-temporarily impaired
- changes in general economic conditions
- legislative or regulatory changes
- downturn in demand for loan, deposit and other financial services in the Corporation s market area
- increased competition from other banks and non-bank providers of financial services
- technological changes and increased technology-related costs
- changes in accounting principles, or the application of generally accepted accounting principles.

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

REFERENCES TO 2008 AND 2007

Unless otherwise noted, all references to 2008 in the following discussion of operating results are intended to mean the nine months ended September 30, 2008, and similarly, references to 2007 relate to the nine months ended September 30, 2007.

EARNINGS OVERVIEW

Net income in 2008 was $7,881,000 in the first nine months of 2008, as compared to $7,242,000 in 2007. Net income per share was $0.88 (basic and diluted), for the first nine months of 2008 compared to $0.83 per share (basic and diluted) for 2007, an increase of 6.0% in diluted net income per share. Return on average equity increased to 7.88% for 2008, up from 7.02% in 2007.

Pre-tax losses from available-for-sale securities totaled $5,460,000 in the first nine months of 2008, as compared to $79,000 in the first nine months of 2007. Securities losses in 2008 included the effects of other-than-temporary impairment (OTTI) charges on pooled trust-preferred securities totaling $4,289,000 and bank stocks totaling $1,878,000. Excluding the after-tax impact of losses on available-for-sale securities, diluted net income per share for the nine months ended September 30, 2008 would have been $1.28, or 54.2% higher than the corresponding amount for the first nine months of 2007.

Pooled trust-preferred securities are long-term instruments, mainly issued by banks, with 30 or more companies included in each pool. The OTTI charges on pooled trust-preferred securities resulted from management s assessment that it is unlikely all previously anticipated principal and interest will be received on three of the securities. Accordingly, management wrote down the cost basis of these three securities to their estimated fair values as of September 30, 2008. After the impact of the OTTI charges, C&N s cost basis in pooled trust-preferred securities totaled $86.6 million, and the estimated fair value at September 30, 2008 was $63.2 million.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

Other significant changes in the components of earnings for the first nine months of 2008, as compared to the same period in 2007, were as follows:

The interest margin increased by $5,031,000, or 18.8% in 2008. The improved interest margin includes the impact of the Citizens Bancorp, Inc. acquisition, which was effective May 1, 2007, compared to the full year-to-date period of 2008. In addition, the interest margin has been positively impacted by lower short-term market interest rates, which have reduced interest rates paid on deposits and borrowings, and by higher earnings on the investment portfolio resulting from higher average total holdings of securities.

Noninterest income, excluding securities gains (losses) increased $2,095,000, or 27.5%. Service charges on deposit accounts increased $1,416,000, or 77.6%, as a result of growth in deposit volumes from the Citizens Bancorp acquisition, as well as higher fees associated with a new overdraft privilege program. Also, in 2008, noninterest income included a gain of $533,000 from redemption of restricted shares of Visa, resulting from Visa s initial public offering. Trust and Financial Management revenue increased $191,000, or 7.6%, mainly as a result of the addition of Citizens Bancorp.

The provision for loan losses was $669,000 in 2008, or $440,000 higher than the first nine months of 2007.

Third Quarter 2008:

Third quarter 2008 earnings were significantly impacted by OTTI losses on securities, as discussed above, including pre-tax losses from OTTI charges on pooled trust-preferred securities of $4,289,000 and bank stocks of $458,000. Diluted net income per share for the third quarter 2008 was $0.11. Excluding the impact of losses on available-for-sale securities, diluted net income per share for the third quarter 2008 would have been $0.44, as compared to $0.32 in the third quarter 2007. The net interest margin was $1,594,000, or 16.8%, higher in the third quarter 2008 than in the third quarter 2007.

Third quarter 2008 diluted net income per share, excluding losses from available-for-sale securities, is $0.04 lower than corresponding second quarter 2008 results. Although the net interest margin increased $452,000 in the third quarter 2008 over the prior quarter, the provision for loan losses increased $517,000, and noninterest expenses increased $479,000. The Corporation benefited from a negative provision for loan losses in the second quarter 2008 of $376,000, resulting from receipt of a payoff on a commercial loan for which an allowance had been established. In the third quarter 2008, increases in noninterest expense included professional fees and severance costs associated with organizational restructuring activities designed to generate future improvements in efficiency and profitability, as well as increases in FDIC insurance costs and charitable contributions.

TABLE I QUARTERLY FINANCIAL DATA

(In Thousands)	Sept. 30, 2008	June 30, 2008	Mar. 31, 2008	Dec. 31, 2007	Sept. 30, 2007	June 30, 2007	Mar. 31, 2007
Interest income	$18,575	$18,373	$18,700	$18,228	$18,058	$17,692	$16,243
Interest expense	7,474	7,724	8,656	8,679	8,551	8,679	8,000
Interest margin	11,101	10,649	10,044	9,549	9,507	9,013	8,243
Provision for loan losses	141	(376)	904	300			229
Interest margin after provision for loan losses	10,960	11,025	9,140	9,249	9,507	9,013	8,014
Other income	3,062	3,155	3,487	2,831	2,877	2,644	2,088
Net (losses) gains on available-for-sale	(4,483)	(867)	(110)	206	(68)	(1,172)	1,161

securities							
Other expenses	8,736	8,257	8,464	8,156	8,691	8,189	8,247
Income before income tax provision	803	5,056	4,053	4,130	3,625	2,296	3,016
Income tax provision	(209)	1,303	937	948	777	360	558
Net income	$ 1,012	$ 3,753	$ 3,116	$ 3,182	$ 2,848	$ 1,936	$ 2,458
Net income per share basic	$ 0.11	$ 0.42	$ 0.35	$ 0.35	$ 0.32	$ 0.22	$ 0.29
Net income per share diluted	$ 0.11	$ 0.42	$ 0.35	$ 0.35	$ 0.32	$ 0.22	$ 0.29

17

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

The number of shares used in calculating net income per share for each quarter presented in Table I reflect the retroactive effect of stock dividends.

Prospects for the Remainder of 2008

Despite substantial write-downs of securities, earnings have increased for the first nine months of 2008 over the same period in 2007, and there are many factors pointing to continued good operating results in the fourth quarter 2008. The largest area of concern for the remainder of 2008 is the potential need to record more losses from the securities portfolio, as described in more detail below.

Because current economic conditions are volatile, management and the Corporation s Board of Directors are considering raising more capital in the fourth quarter 2008 by issuing preferred stock to enable participation in the TARP Capital Purchase Program (described in more detail in the Stockholders Equity and Capital Adequacy section of Management s Discussion and Analysis). The additional capital that could become available under the TARP Capital Purchase Program would provide some protection in case additional securities losses occur, or if local economic conditions worsen and the Corporation begins to experience higher levels of loan losses than it has experienced in the first nine months of 2008. Further, the additional capital may position the Corporation to improve profitability through increased lending, acquisitions or other means. Based on the Corporation s risk-weighted assets as of September 30, 2008, the total amount of preferred stock issued could be as high as $26.5 million. The Corporation s ability to participate in the TARP Capital Purchase Program is dependent on: (1) shareholder approval of an amendment to the Articles of Incorporation to permit issuance of the preferred shares, and (2) approval by banking regulatory agencies and the Treasury Department.

As described in more detail in Item 3, Quantitative and Qualitative Disclosures About Market Risk, the Corporation is liability sensitive, meaning that its sources of funds (mainly deposits and borrowings) tend to re-price more quickly on average when interest rates change than do its earning assets (mainly loans and available-for-sale debt securities). Accordingly, the Corporation tends to generate lower earnings when short-term interest rates rise and higher earnings when short-term rates fall. With reductions in the Fed Funds target rate (which has fallen from 5.25% in August 2007 to its early-November 2008 level of 1%), the Corporation has experienced overall reductions in its cost of funds and improvement in its net interest margin over the course of 2008.

The provision for loan losses for the first nine months of 2008 was $669,000, including a charge to earnings of $141,000 in the third quarter, a credit of $376,000 in the second quarter and a charge to earnings of $904,000 in the first quarter. Issues related to larger commercial borrowers significantly affect the Corporation s provision for loan losses in any particular period. Accordingly, the amount of loan loss provision for the remainder of 2008 will depend substantially on the credit status of the commercial portfolio. Although management is concerned about the condition of the national economy and the potential for problems in our market area, to date the Corporation has not experienced significant deterioration in loan delinquencies, nor a noticeable change in volume of activity related to troubled debts or foreclosures. The Corporation has not originated interest only mortgages, loans without documentation of the borrowers sources of income or net worth, or other types of subprime mortgage loans that have received negative publicity in 2007 and 2008.

Benefits under the Corporation s defined benefit pension plan were frozen, and a decision was made to terminate the Plan, effective December 31, 2007. Earlier in 2008, management expected the Corporation to realize a loss from settlement of the defined benefit pension plan at the time it would be required to fund the final amounts necessary to extinguish its obligations under the Plan. However, the cost of the annuities purchased to settle obligations to retired participants receiving benefits was substantially less than anticipated, and the Corporation had a gain of $71,000 from settlement of the Plan in the third quarter 2008. As reflected in Note 6 to the consolidated financial statements, in the first nine months of 2008, the Corporation recorded expense from the defined benefit plan of $228,000, excluding the gain from settlement. For the year ended December 31, 2007, when a significant amount of service cost was still accruing, expense from the defined benefit plan (excluding a loss from curtailment of $77,000) totaled $495,000. Also in 2008, employer matching contributions under the Corporation s Employee Savings & Retirement Plan (a 401(k) plan), were increased, which will result in an estimated increase in expense of $150,000 for the year. Going forward, management expects the net impact of terminating the defined benefit plan and increasing the Savings & Retirement

Plan contributions to be lower ongoing employee benefit expenses.

A major variable that affects the Corporation s earnings is securities gains and losses. In the first nine months of 2008, the Corporation reported realized losses from available-for-sale securities of $5,460,000, including the effect of pretax write-downs of impaired trust-preferred securities by $4,289,000 and bank stocks by $1,878,000. The Corporation s losses from trust-preferred securities and bank stocks stem from the much-publicized economic

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

problems affecting the national and international economy, which have particularly hurt the banking industry. Although management believes these conditions to be cyclical, opportunities for realized gains from bank stocks are expected to be limited in the fourth quarter 2008, and (after the effect of the write-downs) the Corporation has significant unrealized losses on its holdings of trust-preferred securities as of September 30, 2008. Management has reviewed its holdings of bank stocks, trust-preferred securities and other securities as of September 30, 2008, and concluded that with the exception of the trust-preferred securities and bank stocks that have been written down through earnings the remaining unrealized losses are considered temporary. Notes 4 and 5 to the consolidated financial statements provide more detail concerning the Corporation s processes for evaluating securities for other-than-temporary impairment, and for valuation of trust-preferred securities. Management will continue to closely monitor the status of impaired securities in the fourth quarter 2008.

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

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

As described in Note 5 to the consolidated financial statements, at September 30, 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. At September 30, 2008, management calculated the fair values of pooled trust-preferred securities by applying discount rates to estimated cash flows for each security. Management estimated the cash flows a market participant would expect to receive 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 market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amounts calculated by management.

As described in Note 4 to the consolidated financial statements, management evaluates securities for other-than-temporary impairment. 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) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Management s estimates of cash flows used to evaluate other-than-temporary impairment of pooled trust-preferred securities are based on sensitive assumptions, and market participants might use substantially different assumptions, which could produce different conclusions for each security. Also, management s assessments of the likelihood and potential for recovery in value of equity securities (mainly, bank stocks) are subjective, and based on sensitive assumptions.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

NET INTEREST MARGIN

The Corporation s primary source of operating income is represented by the net interest margin. The net interest margin 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 margin for 2008 and 2007. 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 margin 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.

The fully taxable equivalent net interest margin was $33,374,000 in 2008, which is $5,181,000 (18.4%) higher than in 2007. As shown in Table IV, net increases in volume had the effect of increasing net interest income $1,807,000 in 2008 over 2007, and interest rate changes had the effect of increasing net interest income $3,374,000. Increases in the volume of earning assets and interest-bearing liabilities were significantly affected by the acquisition of Citizens Trust Company on May 1, 2007. The most significant components of the volume changes in interest income in 2008 were an increase of $4,040,000 attributable to growth in the available-for-sale securities portfolio and an increase of $975,000 attributable to loan growth. The most significant volume change in interest expense in 2008 was an increase of $2,927,000 resulting from an increase in long-term borrowings. As presented in Table III, the Interest Rate Spread (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.23% in the first nine months of 2008, as compared to 2.92% for the year ended December 31, 2007 and 2.89% in the first nine months of 2007.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled $57,228,000 in 2008, an increase of 7.1% over 2007. Income from available-for-sale securities increased $3,890,000, or 26.6%, and interest and fees from loans increased $22,000, or 0.1%. As indicated in Table III, total average available-for-sale securities in 2008 rose to $447,354,000, an increase of $99,737,000, or 28.7% from 2007. Throughout much of 2007, proceeds from sales and maturities of securities were used, in part, to help fund loans and pay off borrowings. In December 2007, the Corporation purchased approximately $86,152,000 in mortgage-backed securities in connection with two repurchase agreements. During 2008, the Corporation has increased its holdings of mortgage-backed securities and municipal bonds as securities became available at attractive prices. The average rate of return on available-for-sale securities was 5.53% for 2008, down from the 5.65% return for the year ended December 31, 2007 and 5.62% in the first nine months of 2007.

The average balance of gross loans increased 2.5% to $742,018,000 in 2008 from $723,794,000 in the first nine months of 2007. Excluding the acquisition of Citizens Trust Company, the balance of residential mortgages has remained nearly unchanged in 2008, and there has been a modest decrease in the balance of consumer loans. Growth in the loan portfolio has come primarily from several large loans made to commercial and non-profit entities. The average rate of return on loans was 6.92% in 2008, down from the 7.10% return for the year ended December 31, 2007 and 7.10% in the first nine months of 2007.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense decreased $1,376,000, or 5.5%, to $23,854,000 in 2008 from $25,230,000 in 2007. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 3.14% in 2008, from 3.70% for the year ended December 31, 2007 and 3.72% in the first nine months of 2007.

From Table III, you can calculate that total average deposits (interest-bearing and noninterest-bearing) increased 4.3%, to $843,950,000 in 2008 from $809,001,000 in the first nine months of 2007. The average rates incurred on deposit accounts have decreased significantly in the first nine months of 2008 as compared to the first nine months of 2007. The decreases in rates reduced interest expense on deposits by $4,347,000.

The combined average total short-term and long-term borrowed funds increased $84,680,000 to $296,215,000 in 2008 from $211,535,000 in the first nine months of 2007. In December 2007, the Corporation entered into two repurchase agreements totaling $80,000,000; the proceeds were used to purchase mortgage-backed securities as described above. The average rate on long-term borrowings was 4.25% in 2008, up from 4.11% in the first nine months of 2007.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
TABLE II ANALYSIS OF INTEREST INCOME AND EXPENSE

(In Thousands)	Nine Months Ended September 30, 2008	2007	Increase/ (Decrease)
INTEREST INCOME			
Available-for-sale securities:			
Taxable	$15,206	$11,618	$ 3,588
Tax-exempt	3,308	3,006	302
Total available-for-sale securities	18,514	14,624	3,890
Held-to-maturity securities, Taxable	18	18	
Trading securities	90	66	24
Interest-bearing due from banks	27	74	(47)
Federal funds sold	116	200	(84)
Loans:			
Taxable	36,836	36,889	(53)
Tax-exempt	1,627	1,552	75
Total loans	38,463	38,441	22
Total Interest Income	57,228	53,423	3,805
INTEREST EXPENSE			
Interest checking	794	1,485	(691)
Money market	3,265	4,535	(1,270)
Savings	249	256	(7)
Certificates of deposit	6,978	8,085	(1,107)
Individual Retirement Accounts	3,650	4,413	(763)
Other time deposits	5	6	(1)
Short-term borrowings	761	1,397	(636)
Long-term borrowings	8,152	5,053	3,099
Total Interest Expense	23,854	25,230	(1,376)
Net Interest Income	$33,374	$28,193	$ 5,181

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

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
Table III Analysis of Average Daily Balances and Rates

(Dollars in Thousands)	9 Months Ended 9/30/2008 Average Balance	Rate of Return/ Cost of Funds %	Year Ended 12/31/2007 Average Balance	Rate of Return/ Cost of Funds %	9 Months Ended 9/30/2007 Average Balance	Rate of Return/ Cost of Funds %
EARNING ASSETS						
Available-for-sale securities, at amortized cost:						
Taxable	$ 380,650	5.34%	$ 290,743	5.49%	$ 285,215	5.45%
Tax-exempt	66,704	6.62%	62,065	6.43%	62,402	6.44%
Total available-for-sale securities	447,354	5.53%	352,808	5.65%	347,617	5.62%
Held-to-maturity securities, Taxable	408	5.89%	412	5.83%	412	5.84%
Trading securities	1,972	6.10%	1,665	5.89%	1,541	5.73%
Interest-bearing due from banks	1,302	2.77%	1,864	4.67%	2,058	4.81%
Federal funds sold	6,135	2.53%	4,017	5.25%	5,091	5.25%
Loans:						
Taxable	708,714	6.94%	696,667	7.13%	691,194	7.14%
Tax-exempt	33,304	6.53%	32,602	6.46%	32,600	6.37%
Total loans	742,018	6.92%	729,269	7.10%	723,794	7.10%
Total Earning Assets	1,199,189	6.37%	1,090,035	6.62%	1,080,513	6.61%
Cash	20,111		19,485		19,488	
Unrealized gain/loss on securities	(20,535)		(324)		553	
Allowance for loan losses	(8,875)		(8,697)		(8,662)	
Bank premises and equipment	27,305		26,767		26,337	
Intangible Asset Core Deposit Intangible	1,182		1,287		1,239	
Intangible Asset Goodwill	12,026		8,864		7,810	
Other assets	51,148		41,487		40,462	
Total Assets	$1,281,551		$1,178,904		$1,167,740	
INTEREST-BEARING LIABILITIES						
Interest checking	$ 81,302	1.30%	$ 75,488	2.42%	$ 75,576	2.63%
Money market	192,528	2.27%	183,178	3.29%	183,798	3.30%

Savings	66,859	0.50%	62,976	0.54%	62,702	0.55%
Certificates of deposit	239,971	3.88%	242,822	4.44%	242,189	4.46%
Individual Retirement Accounts	137,785	3.54%	131,158	4.50%	130,099	4.54%
Other time deposits	1,474	0.45%	1,283	0.55%	1,467	0.55%
Short-term borrowings	39,904	2.55%	48,373	3.98%	47,266	3.95%
Long-term borrowings	256,311	4.25%	170,229	4.17%	164,269	4.11%
Total Interest-bearing Liabilities	1,016,134	3.14%	915,507	3.70%	907,366	3.72%
Demand deposits	124,031		115,350		113,170	
Other liabilities	7,892		9,378		9,697	
Total Liabilities	1,148,057		1,040,235		1,030,233	
Stockholders equity, excluding other comprehensive income/loss	147,445		140,035		138,299	
Other comprehensive income/loss	(13,951)		(1,366)		(792)	
Total Stockholders Equity	133,494		138,669		137,507	
Total Liabilities and Stockholders Equity	$1,281,551		$1,178,904		$1,167,740	
Interest Rate Spread		3.23%		2.92%		2.89%
Net Interest Income/Earning Assets		3.72%		3.51%		3.49%

Table of Contents

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

	YTD Ended 9/30/08 vs. 9/30/07		
(In Thousands)	**Change in Volume**	**Change in Rate**	**Total Change**
EARNING ASSETS			
Available-for-sale securities:			
Taxable	$3,827	$ (239)	$ 3,588
Tax-exempt	213	89	302
Total available-for-sale securities	4,040	(150)	3,890
Held-to-maturity securities, Taxable			
Trading securities	20	4	24
Interest-bearing due from banks	(22)	(25)	(47)
Federal funds sold	35	(119)	(84)
Loans:			
Taxable	940	(993)	(53)
Tax-exempt	35	40	75
Total loans	975	(953)	22
Total Interest Income	5,048	(1,243)	3,805
INTEREST-BEARING LIABILITIES			
Interest checking	106	(797)	(691)
Money market	208	(1,478)	(1,270)
Savings	17	(24)	(7)
Certificates of deposit	(73)	(1,034)	(1,107)
Individual Retirement Accounts	250	(1,013)	(763)
Other time deposits		(1)	(1)
Short-term borrowings	(194)	(442)	(636)
Long-term borrowings	2,927	172	3,099
Total Interest Expense	3,241	(4,617)	(1,376)
Net Interest Income	$1,807	$ 3,374	$ 5,181

(1) Changes in income on tax-exempt securities and loans are presented on a fully taxable-equivalent basis, using the

Corporation s marginal federal income tax rate of 34%.

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

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
TABLE V COMPARISON OF NONINTEREST INCOME

	9 Months Ended	
(In Thousands)	**Sept. 30, 2008**	**Sept. 30, 2007**
Trust and financial management revenue	$ 2,697	$2,506
Service charges on deposit accounts	3,240	1,824
Service charges and fees	569	501
Insurance commissions, fees and premiums	246	368
Increase in cash surrender value of life insurance	580	515
Other operating income	2,372	1,895
Total other operating income, before realized losses on available-for-sale securities, net	9,704	7,609
Net losses on available-for-sale securities	(5,460)	(79)
Total Other Income	$ 4,244	$7,530

Total noninterest income decreased $3,286,000 or 43.6%, in 2008 compared to 2007. Net losses on available-for-sale securities, which are discussed in the Earnings Overview section of Management s Discussion and Analysis, represent an aggregate decrease of $5,381,000 from 2007. Excluding such losses, other operating income items provided an increase of $2,095,000 or 27.5% in 2008 over 2007. Items of significance are as follows:

Service charges on deposit accounts increased $1,416,000 or 77.6% in 2008 as compared to 2007. A new overdraft privilege program implemented in early 2008 represents substantially all of the category increase.

Service charges and fees increased $68,000, or 13.6%, in 2008 over 2007. Within this category, the increase relates to the effect of an increase in the number of ATMs, including those from the Citizens Trust acquisition. In addition, a new fee schedule was adopted in the last quarter of 2007, contributing to the increase in ATM fees.

Trust and financial management revenue increased $191,000, or 7.6%, in 2008 over 2007, mainly as a result of the addition of Citizens Trust. The acquisition of Citizens Trust provided $390,000 (14.5%) of the aggregate 2008 trust revenues, and represents $105,000 (55.2%) of the related increase in trust revenues. In addition, new trust operations for the New York State operations (which began in 2007) provided $37,000, or 19.3%, of the aggregate increase in trust revenues. Trust revenues are heavily impacted by the valuation of assets under management. Assets under management amounted to $602,072,000 at September 30, 2008. The current valuation is 11.8% lower than one year earlier primarily due to recent stock market declines.

Insurance commissions, fees and premiums have decreased $122,000, or 33.2% in 2008 as compared to 2007. The decrease primarily relates to the reduction in revenues from credit-related insurance products for Bucktail Life Insurance Company.

The increase in the cash surrender value of life insurance increased $65,000, or 12.6%, in 2008 over 2007. Bank owned life insurance acquired with Citizens Trust represents $59,000 of the total increase.

Other operating income reflects a net increase of $477,000, or 25.2%, in 2008 over 2007. The most significant increase was a gain of $533,000 in 2008 from the redemption of restricted shares of Visa, resulting from Visa s initial public offering. Also, interchange fees related to debit card transactions provided a 2008 increase of

$202,000, which is primarily attributed to the additional volume for the Citizens Trust Company branches. Other operating income was offset by an increase in net losses on trading securities of $120,000 in 2008.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
TABLE VI- COMPARISON OF NONINTEREST EXPENSE

	9 Months Ended	
(In Thousands)	**Sept. 30, 2008**	**Sept. 30, 2007**
Salaries and wages	$11,319	$10,769
Pensions and other employee benefits	3,312	3,190
Occupancy expense, net	2,160	1,954
Furniture and equipment expense	1,982	2,104
Pennsylvania shares tax	876	707
Other operating expense	5,808	6,403
Total Other Expense	$25,457	$25,127

Total noninterest expense increased $330,000, or 1.3%, in 2008 over 2007. The increase in noninterest expense includes the effect of the May 2007 Citizens Bancorp acquisition, with additional personnel and other costs associated with adding three operating locations. Significant changes in 2008 as compared to 2007 include the following:

Salaries and wages increased $550,000, or 5.1%. The primary increase in salaries is associated with the 2008 accruals for various incentive compensation programs of $682,000 more than the related 2007 incentives. Other compensation costs, primarily severance related costs, increased $177,000 in 2008. Salaries and wages associated with staff additions from the Citizens Bancorp acquisition have been fully offset by reductions in personnel that have taken place over the last half of 2007 and the first nine months of 2008.

Pensions and other employee benefits increased $122,000, or 3.8%. Within this category, there were several significant changes, summarized as follows:

- o Group health insurance expense was $189,000 higher in 2008, mainly because an experience-related refund reduced expense in 2007.

- o Employer contributions expense associated with the Savings & Retirement Plan (a 401(k) plan) and Employee Stock Ownership Plan was $156,000 higher in 2008 than in 2007. The increased expense relates primarily to the Corporation s increase in employer matching contributions in connection with its decision, discussed earlier, to terminate its defined benefit pension plan.

- o Retiree sick pay compensation increased $56,000 in 2008 due to the acceleration of payments required under the program related to the reduction in personnel described above.

- o Costs for benefit plan consultants increased $56,000 due to plan amendments related to the pension plan termination.

- o Payroll tax expense decreased $93,000. In the first quarter 2007, the Corporation recorded payroll tax expense associated with incentive bonuses that were determined based on 2006 performance and paid in January 2007. There were no incentive bonuses awarded based on 2007 performance, and accordingly, no bonus-related payroll tax expense was recorded in 2008. In addition, reduced payroll taxes for 2008 were associated with the reductions in personnel discussed above.

- o Defined benefit pension plan expense decreased $214,000, as a result of the decision to freeze and terminate the plan, effective December 31, 2007. The Corporation funded and settled its obligations under the Plan, and recorded a gain of $71,000 from settlement, in the third quarter 2008.

Occupancy expense increased $206,000, or 10.5%. Approximately $124,000 of the increase relates to the addition of the Citizens Trust Company branches. Also, utility costs, real estate taxes and building maintenance costs were higher in the first 9 months of 2008 compared to 2007.

CITIZENS & NORTHERN CORPORATION FORM 10-Q

Pennsylvania shares tax expense increased $169,000, or 23.9%, mainly because of the addition of Citizens Trust Company s historic asset and equity values to the tax base.

Other operating expense decreased $595,000, or 9.3%. This category includes many varieties of expenses, with significant increases and decreases in some of the individual expenses, as follows:

- Decrease in operating expenses of $348,000 from the recovery of $174,000 in 2008 from an insurance claim related to costs recorded in the third quarter of 2007.
- Decrease of $221,000 related to core system conversion expense incurred in 2007 to convert the computer systems used for both the New York State locations and the Citizens Bancorp locations to the same core computer system used by C&N Bank.
- Decrease of $145,000 related to a loss on disposition of telephone equipment recorded in 2007.
- Settlement of certain sales tax issues in 2008 reduced overall costs by $94,000 associated with recovered costs or related consulting fees in 2007.
- Costs associated with other real estate (OREO) property activity decreased $59,000 due to improved disposition activity and one large recovery of $21,000 in 2008.
- Attorney fees decreased $58,000 in 2008 compared to 2007.
- Professional services increased $323,000 in 2008, mainly because $359,000 was incurred for two projects initiated to enhance non-interest income (overdraft privilege program discussed above) and to improve the bank operating structure, as well as future efficiency and profitability.
- FDIC insurance costs increased to $161,000 in 2008, or $86,000 higher than in 2007.
- Amortization of core deposit intangibles increased $125,000, including an increase of $141,000 attributable to the Citizens Bancorp acquisition.

FINANCIAL CONDITION

Significant changes in the average balances of the Corporation s earning assets and interest-bearing liabilities are described in the Net Interest Margin 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.

Total capital purchases for 2008 are estimated at approximately $1.0 million. Management does not expect capital expenditures to have a material, detrimental effect on the Corporation s financial condition in 2008.

PROVISION AND ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at a level that, in management s judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management s evaluation of the collectability of the loan portfolio. In evaluating collectability, management considers a number of factors, including the status of specific impaired loans, trends in historical loss experience, delinquency trends, credit concentrations, comparison of historical loan loss data to that of other financial institutions and economic conditions within the Corporation s market area. Allowances for impaired loans are determined based on collateral values or the present value of estimated cash flows. The allowance is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs, net of recoveries.

There are two major components of the allowance (1) SFAS 114 allowances on larger loans, mainly commercial purpose, determined on a loan-by-loan basis; and (2) SFAS 5 allowances estimates of losses incurred on the remainder of the portfolio, determined based on collective evaluation of impairment for various categories of loans. SFAS 5 allowances include a portion based on historical net charge-off experience, and a portion based on evaluation of qualitative factors.

CITIZENS & NORTHERN CORPORATION FORM 10-Q

Each quarter, management performs a detailed assessment of the allowance and provision for loan losses. A management committee called the Watch List Committee performs this assessment. Quarterly, the Watch List Committee and the applicable Lenders discuss each loan relationship under review, and reach a consensus on the appropriate SFAS 114 estimated loss amount for the quarter. The Watch List Committee s focus is on ensuring that all pertinent facts have been considered, and that the SFAS 114 loss amounts are reasonable. The assessment process includes review of certain loans reported on the Watch List. All loans, for which Lenders or the Credit Administration staff has assigned a risk rating of Special Mention, Substandard, Doubtful or Loss, are included in the Watch List. The scope of loans evaluated individually for impairment (SFAS 114 evaluation) include all loan relationships greater than $200,000 for C&N Bank loans, and $50,000 for First State Bank, for which there is at least one extension of credit graded Special Mention, Substandard, Doubtful or Loss. Also, loan relationships less than $200,000 in the aggregate, but with an estimated loss of $100,000 or more, are individually evaluated for impairment.

The SFAS 5 component of the allowance includes estimates of losses incurred on loans that have not been individually determined to be impaired. Management uses loan categories included in the Call Report (a quarterly report filed by FDIC-insured banks) to identify categories of loans with similar risk characteristics, and multiplies the loan balances for each category as of each quarter-end by two different factors to determine the SFAS 5 allowance amounts. These two factors are based on: (1) historical net charge-off experience, and (2) qualitative factors. The sum of the allowance amounts calculated for each risk category, including both the amount based on historical net charge-off experience and the amount based on evaluation of qualitative factors, is equal to the total SFAS 5 component of the allowance.

The historical net charge-off portion of the SFAS 5 allowance component is calculated by the Accounting Department as of the end of the applicable quarter. For each loan classification category used in the Call Report, the Accounting Department multiplies the outstanding balance as of the quarter-end (excluding impaired loans) by the ratio of net charge-offs to average quarterly loan balances for the previous three calendar years.

Effective in the second quarter 2005, management began to calculate the effects of specific qualitative factors criteria to determine a percentage increase or decrease in the SFAS 5 allowance, in relation to the historical net charge-off percentage. The qualitative factors analysis involves assessment of changes in factors affecting the portfolio, to provide for estimated differences between losses currently inherent in the portfolio and the amounts determined based on recent historical loss rates and from identification of losses on specific individual loans. A management committee called the Qualitative Factors Committee meets quarterly, near the end of the final month of each quarter. The Qualitative Factors Committee discusses several qualitative factors, including economic conditions, lending policies, changes in the portfolio, risk profile of the portfolio, competition and regulatory requirements, and other factors, with consideration given to how the factors affect three distinct parts of the loan portfolio: Commercial, Mortgage and Consumer. During or soon after completion of the meeting, each member of the Committee prepares an update to his or her recommended percentage adjustment for each qualitative factor, and average qualitative factor adjustments are calculated for Commercial, Mortgage and Consumer loans. The Accounting Department multiplies the outstanding balance as of the quarter-end (excluding impaired loans) by the applicable qualitative factor percentages, to determine the portion of the SFAS 5 allowance attributable to qualitative factors.

The allocation of the allowance for loan losses table (Table VIII) includes the SFAS 114 component of the allowance on the line item called Impaired Loans. SFAS 5 estimated losses, including both the portion determined based on historical net charge-off results, as well as the portion based on management s assessment of qualitative factors, are allocated in Table VIII to the applicable categories of commercial, consumer mortgage and consumer loans. In periods prior to 2005, the portion of the allowance determined by management s subjective assessment of economic conditions and other factors (which is now calculated using the qualitative factors criteria described above) was reflected completely in the unallocated component of the allowance.

The allowance for loan losses totaled $8,498,000 at September 30, 2008, compared to $8,859,000 at December 31, 2007. As shown in Table VII, net charge-offs to date in 2008 totaled $1,125,000, which is substantially higher than the same period in 2007, as well as the historical annual levels for recent years shown in the table. In the first quarter 2008, the Corporation charged off $780,000 from three commercial loan relationships for which SFAS 114 allowances of $775,000 had been recorded as of December 31, 2007. Table VII shows the provision for loan losses totaled $669,000 in 2008, compared to $229,000 in the first nine months of 2007. The total amount of the provision for loan losses in each period is determined based on the amount required to maintain an appropriate allowance in light of all of the factors described above. The 2008 provision for loan losses reflects a credit provision for the second quarter related to the reversal of the SFAS 114 allowance of $450,000 associated with one commercial loan relationship that has been paid off. The 2008 provision also includes the effects of establishing an SFAS 114 allowance of $250,000 on one other commercial loan relationship, as well as increasing the unallocated portion of the allowance by $381,000.

CITIZENS & NORTHERN CORPORATION FORM 10-Q

Table IX presents information related to past due and impaired loans. Total impaired loans amounted to $6,166,000 at September 30, 2008 up from $4,612,000 at June 30, 2008 yet comparable to the $6,159,000 at March 31, 2008, and $6,218,000 at December 31, 2007. Nonaccrual loans totaled $7,782,000 at September 30, 2008 up from $5,813,000 at June 30, 2008, and more comparable to $7,316,000 at March 31, 2008, and $6,955,000 at December 31, 2007. The SFAS 114 valuation allowance on impaired loans totaled $1,161,000 at September 30, 2008 compared to $1,180,000 at June 30, 2008, yet down from $1,723,000 at March 31, 2008, and $2,255,000 at December 31, 2007. The decrease in the SFAS 114 valuation allowance was primarily attributed to the pay-off, described above, of one commercial loan relationship with a SFAS 114 allowance of $450,000, as well as the previously described charge-offs of $780,000 associated with three other commercial loan relationships. Such decreases were partially offset by a SFAS 114 valuation allowance of $250,000 for one additional commercial relationship considered to be impaired. At September 30, 2008, the loans past due 90 days or more and still accruing decreased to $1,378,000 primarily related to collection of one commercial loan relationship of $1,614,000. 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 estimated as of September 30, 2008. Management continues to closely monitor its commercial loan relationships for possible credit losses, and will adjust its estimates of loss and decisions concerning nonaccrual status, if appropriate.

Tables VII, VIII, IX and X present an analysis of the allowance for loan losses, the allocation of the allowance, information concerning impaired and past due loans and a five-year summary of loans by type.

TABLE VII- ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

	9 Months Ended Sept. 30,	**9 Months Ended Sept. 30,**	**Years Ended December 31,**				
(In Thousands)	**2008**	**2007**	**2007**	**2006**	**2005**	**2004**	**2003**
Balance, beginning of year	$8,859	$8,201	$8,201	$8,361	$6,787	$6,097	$5,789
Charge-offs:							
Real estate loans	670	108	196	611	264	375	168
Installment loans	143	141	216	259	224	217	326
Credit cards and related plans	7	4	5	22	198	178	171
Commercial and other loans	305	123	127	200	298	16	303
Total charge-offs	1,125	376	544	1,092	984	786	968
Recoveries:							
Real estate loans	17	6	8	27	14	3	75
Installment loans	61	27	41	65	61	32	52
Credit cards and related plans	3	8	9	25	30	23	17
Commercial and other loans	14	27	28	143	50	18	32
Total recoveries	95	68	86	260	155	76	176
Net charge-offs	1,030	308	458	832	829	710	792

Allowance for loan losses recorded in acquisition		587	587		377		
Provision for loan losses	669	229	529	672	2,026	1,400	1,100
Balance, end of period	$8,498	$8,709	$8,859	$8,201	$8,361	$6,787	$6,097

28

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
TABLE VIII ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES BY TYPE

(In Thousands)	As of Sept. 30, 2008	As of December 31, 2007	2006	2005	2004	2003
Commercial	$2,227	$1,870	$2,372	$2,705	$1,909	$1,578
Consumer mortgage	4,273	4,201	3,556	2,806	513	456
Impaired loans	1,161	2,255	1,726	2,374	1,378	1,542
Consumer	456	533	523	476	409	404
Unallocated	381		24		2,578	2,117
Total Allowance	$8,498	$8,859	$8,201	$8,361	$6,787	$6,097

TABLE IX PAST DUE AND IMPAIRED LOANS

(In Thousands)	As of Sept. 30, 2008	As of June 30, 2008	As of March 31, 2008	As of December 31, 2007	2006	2005	2004	2003
Impaired loans without a valuation allowance	$3,414	$1,512	$1,059	$ 857	$2,674	$ 910	$3,552	$ 114
Impaired loans with a valuation allowance	2,969	3,100	5,100	5,361	5,337	7,306	4,709	4,507
Total impaired loans	$6,383	$4,612	$6,159	$6,218	$8,011	$8,216	$8,261	$4,621
Valuation allowance related to impaired loans	$1,161	$1,180	$1,723	$2,255	$1,726	$2,374	$1,378	$1,542
Total nonaccrual loans	$7,782	$5,813	$7,316	$6,955	$8,506	$6,365	$7,796	$1,145
Total loans past due 90 days or more and still accruing	$1,378	$2,883	$1,470	$1,200	$1,559	$1,369	$1,307	$2,546

TABLE X SUMMARY OF LOANS BY TYPE

(In Thousands)	Sept. 30, 2008	As of December 31, 2007	2006	2005	2004	2003
Real estate construction	$ 34,002	$ 22,497	$ 10,365	$ 5,552	$ 4,178	$ 2,856
	440,001	441,692	387,410	361,857	347,705	330,807

Real estate residential mortgage						
Real estate commercial mortgage	158,972	144,742	178,260	153,661	128,073	100,240
Consumer	29,586	37,193	35,992	31,559	31,702	33,977
Agricultural	4,497	3,553	2,705	2,340	2,872	2,948
Commercial	51,932	52,241	39,135	69,396	43,566	34,967
Other	789	1,010	1,227	1,871	1,804	1,183
Political subdivisions	37,628	33,013	32,407	27,063	19,713	17,854
Lease receivables						65
Total	757,407	735,941	687,501	653,299	579,613	524,897
Less: allowance for loan losses	(8,498)	(8,859)	(8,201)	(8,361)	(6,787)	(6,097)
Loans, net	$748,909	$727,082	$679,300	$644,938	$572,826	$518,800

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. 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 mortgage loans and various investment securities. At September 30, 2008, the Corporation had unused borrowing availability with correspondent banks and the Federal Home Loan Bank of Pittsburgh totaling approximately $200,000,000. Additionally, the Corporation uses repurchase agreements placed with brokers to

CITIZENS & NORTHERN CORPORATION FORM 10-Q

borrow funds secured by investment assets, and uses RepoSweep arrangements to borrow funds from commercial banking customers on an overnight basis. Further, if required to raise cash in an emergency situation, the Corporation could sell non-pledged investment securities to meet its obligations. At September 30, 2008, the carrying value of non-pledged available-for-sale securities was $127,391,000.

In October 2008, the Corporation opened a line of credit with the Federal Reserve Bank of Philadelphia s Discount Window. Management intends to use this line solely as a contingency funding source and does not expect to draw on this line of credit unless the Corporation s primary funding sources become unavailable. As collateral for the line, the Corporation pledged available-for-sale securities with a carrying value of approximately $76,000,000 at September 30, 2008 that had previously been unpledged. As of October 31, 2008, the Corporation has approximately $68,000,000 available on this line of credit, and no funds have been advanced.

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

STOCKHOLDERS EQUITY AND CAPITAL ADEQUACY

The Corporation (on a consolidated basis) and the subsidiary Banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Banks must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Banks to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier I capital (as defined) to average assets (as defined). Management believes, as of September 30, 2008 and December 31, 2007, that the Corporation and the Banks meet all capital adequacy requirements to which they are subject. To be categorized as well capitalized, an institution must maintain minimum total risk based, Tier I risk based and Tier I leverage ratios as set forth in the following table. The Corporation s and the Banks actual capital amounts and ratios are also presented in the following table.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

			Minimum Capital Requirement		Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in Thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2008:						
Total capital to risk-weighted assets:						
Consolidated	$141,093	15.96%	$70,723	³8%	n/a	n/a
C&N Bank	112,146	13.23%	67,836	³8%	$84,795	³10%
First State Bank	4,487	23.77%	1,510	³8%	1,888	³10%
Tier 1 capital to risk-weighted assets:						
Consolidated	132,358	14.97%	35,362	³4%	n/a	n/a
C&N Bank	103,620	12.22%	33,918	³4%	50,877	³6%
First State Bank	4,278	22.66%	755	³4%	1,133	³6%
Tier 1 capital to average assets:						
Consolidated	132,358	10.24%	51,704	³4%	n/a	n/a
C&N Bank	103,620	8.33%	49,735	³4%	62,169	³5%
First State Bank	4,278	9.82%	1,742	³4%	2,177	³5%
December 31, 2007:						
Total capital to risk-weighted assets:						
Consolidated	$140,423	16.52%	$68,020	³8%	n/a	n/a
C&N Bank	112,965	13.90%	65,017	³8%	$81,272	³10%
First State Bank	4,417	19.82%	1,783	³8%	2,229	³10%
Tier 1 capital to risk-weighted assets:						
Consolidated	131,428	15.46%	34,010	³4%	n/a	n/a
C&N Bank	104,297	12.83%	32,509	³4%	48,763	³6%
First State Bank	4,138	18.57%	892	³4%	1,337	³6%
Tier 1 capital to average assets:						
Consolidated	131,428	10.91%	48,164	³4%	n/a	n/a
C&N Bank	104,297	9.08%	45,927	³4%	57,409	³5%
First State Bank	4,138	9.54%	1,734	³4%	2,168	³5%

Management expects the Corporation and the subsidiary banks to maintain capital levels that exceed the regulatory standards for well-capitalized institutions for the foreseeable future. However, if there were significant other-than-

CITIZENS & NORTHERN CORPORATION FORM 10-Q

temporary impairment losses on available-for-sale securities, or if economic conditions continued to worsen to the extent that loan losses or losses on other assets increased significantly from recent historical levels, capital ratios could fall to levels considered less than well-capitalized. Although management does not expect such significant losses will occur within the foreseeable future, the possibility of such losses is one of the reasons management and the Corporation s Board of Directors are considering raising more capital by issuing preferred stock to enable participation in the TARP Capital Purchase Program (described in more detail below). Planned capital expenditures are not expected to have a significantly detrimental effect on capital ratios.

The Corporation s total stockholders equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in Accumulated Other Comprehensive Loss within stockholders equity. Changes in accumulated other comprehensive loss are excluded from earnings and, except for unrealized losses on equity securities, accumulated other comprehensive losses are excluded from the calculation of Tier 1 and Total capital for regulatory purposes. The balance in accumulated other comprehensive losses related to unrealized gains or losses on available-for-sale securities, net of deferred income tax, amounted to $23,149,000 at September 30, 2008, compared to $6,654,000 at December 31, 2007. The change in accumulated other comprehensive losses in the first half of 2008 resulted mainly from an increased amount of unrealized losses on trust-preferred securities, as discussed in Note 4.

The Corporation has recognized a liability for the underfunded balance of its defined benefit pension and postretirement plans, and has recognized a reduction in stockholders equity (included in accumulated other comprehensive loss) for the amount of the liability, net of deferred income tax. As discussed in Note 6, the defined benefit pension plan was terminated as of December 31, 2007, and in the third quarter 2008, the Corporation funded its obligations under the defined benefit pension plan. Accordingly, the balance in accumulated other comprehensive loss related to defined benefit plans as of September 30, 2008 was related exclusively to the postretirement plan. Accumulated other comprehensive loss related to defined benefit obligations was $113,000 at September 30, 2008 and $403,000 at December 31, 2007.

Potential Issuance of Preferred Stock and Participation in TARP Capital Purchase Program

On October 31, 2008, the Corporation filed a preliminary proxy statement with the Securities and Exchange Commission for a special shareholders meeting to amend the Corporation s Articles of Incorporation to create 30,000 shares of preferred stock, $1,000.00 par value per share. The Board of Directors is considering authorizing the issuance of preferred stock, and warrants to purchase common stock, to the United States Department of Treasury pursuant to the terms of the Emergency Economic Stabilization Act of 2008 and the TARP Capital Purchase Program (the Program) established thereunder. The Program was instituted in response to the current credit crisis as a means of facilitating capital growth for the country s financial institutions, which is intended to increase the flow of financing to businesses and consumers. Under the Program, the Treasury Department will purchase up to a predetermined amount of preferred stock from qualifying financial institutions in order to provide such capital. In order to participate in the Program, the Corporation must apply by November 14, 2008, and must receive shareholder approval to amend its Articles of Incorporation to authorize creation of the preferred stock within 30 days after receipt of such approval.

If approved, the Corporation may sell an amount of Senior Preferred shares to the Treasury equal to not less than 1%, and not more than 3%, of the Corporation s risk-weighted assets. Based on the Corporation s risk-weighted assets as of September 30, 2008, the Corporation could issue amounts ranging from approximately $8.8 million to $26.5 million, and management presently expects to apply for the high end of that range. The Senior Preferred shares would qualify as Tier 1 capital and would rank senior to common stock. The Senior Preferred shares would pay a cumulative dividend rate of 5% per annum for the first five years and reset to a rate of 9% per annum after year five. The dividend would be payable quarterly in arrears. The Senior Preferred shares would be non-voting, other than class voting rights on matters that could adversely affect the shares. The Senior Preferred shares could be redeemed after three years at the option of the Corporation for a price equal to the original issue price plus any accrued but unpaid dividends. Prior to the end of three years, the Senior Preferred shares could be redeemed with the proceeds from a qualifying equity offering by the Corporation of any Tier 1 perpetual preferred stock or common stock. The Treasury could also transfer the Senior Preferred shares to a third party at any time. In conjunction with the purchase of Senior Preferred shares, the Treasury would receive warrants to purchase Corporation common stock with an aggregate market price equal to 15% of the Senior Preferred investment. The exercise price on the warrants would be the market price of the Corporation s common stock at the time of issuance, calculated on a 20-trading day trailing average. The warrants would be immediately exercisable and have a term of 10 years, and the Corporation would have to take the steps necessary to register the Senior Preferred shares and the warrants and the underlying common stock purchasable upon exercise with the Securities and Exchange Commission.

CITIZENS & NORTHERN CORPORATION FORM 10-Q

To participate in the program, the Corporation would be required to meet certain standards, including: (i) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the Corporation; (ii) requiring a clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (iii) prohibiting the Corporation from making any golden parachute payment to a senior executive based on applicable Internal Revenue Code provisions; and (iv) agreeing not to deduct for tax purposes executive compensation in excess of $500,000 for each senior executive.

Based on the Program term sheet provided by the Treasury, the following would be the effects on holders of common stock from the issuance of Senior Preferred stock to the Treasury under the Program:

Restrictions on Dividends. For as long as any Senior Preferred shares are outstanding, no dividends could be declared or paid on common shares, nor could the Corporation repurchase or redeem any common shares, unless all accrued and unpaid dividends for all past dividend periods on the Senior Preferred shares had been fully paid. In addition, the consent of the Treasury would be required for any increase in the per share dividends on common shares until the third anniversary of the date of the Senior Preferred investment unless prior to such third anniversary, the Senior Preferred shares were redeemed in whole or the Treasury had transferred all of the Senior Preferred shares to third parties.

Repurchases. The Treasury s consent would be required for any share repurchases (other than (i) repurchases of the Senior Preferred shares and (ii) repurchases of common shares in connection with any benefit plan in the ordinary course of business consistent with past practice) until the third anniversary of the date of this investment unless prior to such third anniversary the Senior Preferred shares had been redeemed in whole or the Treasury had transferred all of the Senior Preferred shares to third parties. In addition, there could be no share repurchases of common shares if prohibited as described under Restrictions on Dividends above.

Voting rights. The Senior Preferred shares would be non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the Senior Preferred shares, (ii) any amendment to the rights of Senior Preferred, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the Senior Preferred. If dividends on the Senior Preferred shares were not paid in full for six dividend periods, whether or not consecutive, the Senior Preferred shares would have the right to elect 2 directors. The right to elect directors would end when full dividends had been paid for four consecutive dividend periods.

INFLATION

The Corporation is significantly affected by the Federal Reserve Board s efforts to control inflation through changes in short-term interest rates. Over the period 2004 through 2006, the Federal Reserve increased the fed funds target rate 17 times, from a low of 1% to 5.25%. The fed funds target rate stayed at 5.25% until August 2007. During that time period, long-term interest rates did not increase as much as short-term rates, which hurt the Corporation s profitability by squeezing the net interest margin. Since August 2007, in response to concerns about weakness in the U.S. economy, the Federal Reserve has lowered the fed funds target rate several times, to its current level of 1%, and long-term rates are now higher than short-term rates. While the Federal Reserve has recently lowered the fed funds target rate, which has lowered short-term rates and therefore the Corporation s cost of funds, in the future inflationary pressures may force the Fed to change course and begin raising rates. Although management cannot predict future changes in the rates of inflation, management monitors the impact of economic trends, including any indicators of inflationary pressures, in managing interest rate and other financial risks.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No.157), to establish a consistent framework for measuring fair value and expand disclosures on fair value measurements. The provisions of SFAS No. 157 are effective beginning in 2008 and affect the Corporation s disclosures of information regarding fair values of financial instruments, but do not have a material effect on the Corporation s financial statements. The FASB issued Staff Position No. 157-3, in October 2008, Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active (FSP FAS 157-3). FSP FAS 157-3 provides guidance and illustration of key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

The disclosures required by SFAS No. 157 are presented in Note 5 to the consolidated financial statements.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments at fair value that are not required to be measured at fair value. It also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007 (the Corporation s 2008 fiscal year). The Corporation has not elected to measure any financial instruments at fair value (other than instruments that were measured at fair value prior to SFAS No. 159), and therefore SFAS No. 159 has not affected the Corporation s financial statements.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations (SFAS No. 141R). SFAS No. 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, SFAS No. 141R will apply to any business combinations the Corporation engages in, starting in 2009.

The FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, in December 2007, which is an amendment of ARB 51 (SFAS No. 160). SFAS No. 160 changes the accounting and reporting for minority interests. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, except for the presentation and disclosure requirements, which will apply retrospectively. Currently, the provisions of SFAS No. 160 would not apply to the Corporation, because the Corporation owns and controls 100% of the entities within its consolidated group.

In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities (SFAS No. 161). SFAS No. 161 requires expanded disclosures regarding derivative instruments and hedging activities. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Currently, the provisions of SFAS No. 161 would not apply to the Corporation, because the Corporation s derivative instruments are not material.

The FASB issued SFAS No. 162, the Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162) in May 2008. The FASB issued SFAS No. 162 to meet its responsibility to identify the sources of accounting principles and the framework for entities to select the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. SFAS 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. Once the statement is effective, the hierarchy of accounting principles under SFAS No. 162 is not expected to require any significant changes to current financial statements and related disclosures of the Corporation.

Also, SFAS No. 163, Accounting for Financial Guarantee Insurance Contracts an interpretation of FASB Statement No. 60 (SFAS No. 163) was issued in May 2008. SFAS No. 163 requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. The Statement requires expanded disclosures about financial guarantee insurance contracts. SFAS No. 163 is expected to improve the quality of information for users of financial statements about the recognition and measurement of claim liabilities because of differing views about when a loss has been incurred under FASB Statement No. 5, Accounting for Contingencies. Currently, the provisions of SFAS No. 163 will not require any additional disclosures by the Corporation, because current financial guarantee insurance contracts are not material.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

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. As discussed in Note 4 to the financial statements, and the Prospects for the Remainder of 2008 section of Management s Discussion and Analysis, the Corporation has significant unrealized losses on its holdings of trust-preferred securities as of September 30, 2008. 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 believes valuations of debt securities at September 30, 2008 have been negatively impacted by events affecting the overall credit markets during the last quarter of 2007 and the first nine months of 2008. There have been widespread disruptions to the normal operation of bond markets. Particularly with regard to trust-preferred securities, trading volume has been limited and consisted almost entirely of sales by distressed sellers. As a result, quoted market prices on many securities have been substantially depressed and the market for pooled trust-preferred securities has become virtually nonexistent. Further, some banking companies that have issued trust-preferred securities have elected to defer payment of interest on these obligations, and a few issuers have defaulted.

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 section of Management s Discussion and Analysis) and ample sources of liquidity (discussed in the Liquidity section of Management s Discussion and Analysis).

Two of the Corporation s major categories of market risk, interest rate risk and equity securities risk, 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. The tables below were prepared based on data as of August 31, 2008 and November 30, 2007. Pro forma adjustments were made to the August 31, 2008 data to incorporate the fair values of the pooled trust preferred securities that were calculated as of September 30, 2008 using discounted cash flow models. Pro forma adjustments were made to the November 30, 2007 data to incorporate the significant leveraged investment purchase transaction (discussed below) that occurred in December 2007.

For purposes of these calculations, the market value of portfolio equity includes the fair values of financial instruments, such as securities, loans, deposits and borrowed funds, and the book values of nonfinancial assets and liabilities, such as premises and equipment and accrued expenses. The model measures and projects potential changes in net interest income, and calculates the discounted present value of anticipated cash flows of financial instruments, assuming an immediate increase or decrease in interest rates. Management ordinarily runs a variety of scenarios within a range of plus or minus 50-300 basis points of current rates.

The table that follows was prepared using the simulation model described above. 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 margin and market value of portfolio equity. Also, the model does not make estimates related to changes in the composition of the deposit portfolio that could occur due to rate competition and the table does not necessarily reflect changes that management would make to realign the portfolio as a result of changes in interest rates.

CITIZENS & NORTHERN CORPORATION FORM 10-Q

In December 2007, the Corporation entered into two repurchase agreements (borrowings) totaling $80 million to fund the purchase of investment securities. In addition to generating positive earnings from the spread of the return on the investment securities over the current cost of the borrowings, the transaction reduces the magnitude of the Corporation s overall liability-sensitive position. Specifically, the borrowings include embedded caps providing that, if 3-month LIBOR were to exceed 5.15%, the interest rate payable on the repurchase agreements would fall, down to a minimum of 0%, based on parameters included in the repurchase agreements. One of the embedded caps expires in December 2010, and the other expires in December 2012.

Short-term interest rates fell significantly in the first eight months of 2008, causing the embedded caps to be less than fully effective in the August 2008 calculations. When the interest rate risk simulation was run using August 2008 data, 3-month LIBOR was at 2.81%. Since the embedded caps described above are effective only when 3-month LIBOR exceeds 5.15%, the Corporation would be unable to realize an interest expense reduction in the scenarios where current rates rise 100 or 200 basis points. Also, the realizable benefit in the scenario where rates rise 300 basis points was substantially less than it had been at November 2007.

The Corporation s Board of Directors has established policy guidelines for acceptable levels of interest rate risk, based on an immediate increase or decrease in interest rates. The policy provides limits at +/- 100, 200 and 300 basis points from current rates for fluctuations in net interest income from the baseline (flat rates) one-year scenario. The policy also limits acceptable market value variances from the baseline values based on current rates. As indicated in the table, the Corporation is liability sensitive, and therefore net interest income and market value generally increase when interest rates fall and decrease when interest rates rise. The table shows that as of November 30, 2007, the changes in net interest income and market value were within the policy limits in all scenarios.

At August 31, 2008, the Corporation was within the policy limits for changes in net interest income but was slightly outside the policy limit for the change in market value at +300 basis points. This change occurred primarily because of the decline in the market value of the investment portfolio (particularly the pooled trust preferred securities). Management has reviewed this with the Board of Directors and will continue to evaluate whether to make any changes to asset or liability holdings in an effort to reduce exposure to rising interest rates.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
TABLE XI THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES
August 31, 2008 Data
(In Thousands)

Next 12 Months Period Ending August 31, 2009

Basis Point Change in Rates	Interest Income	Interest Expense	Net Interest Income (NII)	NII % Change	NII Risk Limit
+300	$81,293	$43,116	$38,177	-13.9%	20.0%
+200	78,802	38,835	39,967	-9.9%	15.0%
+100	76,270	33,609	42,661	-3.8%	10.0%
0	73,647	29,312	44,335	0.0%	0.0%
-100	70,572	25,686	44,886	1.2%	10.0%
-200	66,820	22,956	43,864	-1.1%	15.0%
-300	63,045	22,327	40,718	-8.2%	20.0%

Market Value of Portfolio Equity
at August 31, 2008

Basis Point Change in Rates	Present Value Equity	Present Value % Change	Present Value Risk Limit
+300	$ 64,241	-46.2%	45.0%
+200	80,406	-32.6%	35.0%
+100	100,497	-15.8%	25.0%
0	119,370	0.0%	0.0%
-100	134,001	12.3%	25.0%
-200	136,460	14.3%	35.0%
-300	133,422	11.8%	45.0%

November 30, 2007 Data
(In Thousands)

Next 12 Months Period Ending November 30, 2008

Basis Point Change in Rates	Interest Income	Interest Expense	Net Interest Income (NII)	NII % Change	NII Risk Limit
+300	$82,751	$50,168	$32,583	-16.7%	20.0%
+200	80,606	44,823	35,783	-8.5%	15.0%
+100	78,352	40,696	37,656	-3.7%	10.0%
0	75,869	36,776	39,093	0.0%	0.0%
-100	72,910	31,608	41,302	5.7%	10.0%
-200	69,244	27,524	41,720	6.7%	15.0%
-300	65,322	23,907	41,415	5.9%	20.0%

Market Value of Portfolio Equity
at November 30, 2007

Basis Point Change in Rates	Present Value Equity	Present Value % Change	Present Value Risk Limit
+300	$ 97,288	-34.0%	45.0%
+200	117,811	-20.1%	35.0%
+100	133,434	-9.5%	25.0%
0	147,388	0.0%	0.0%
-100	159,195	8.0%	25.0%
-200	161,102	9.3%	35.0%
-300	162,845	10.5%	45.0%

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

EQUITY SECURITIES RISK

The Corporation s equity securities portfolio consists primarily of investments in stock of banks and bank holding companies. The Corporation also owns some other stocks and mutual funds.

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. Most U.S. bank stock prices fell in value significantly in the first nine months of 2008. As discussed further in the Earnings Overview section of Management s Discussion and Analysis, the Corporation has recognized other-than-temporary impairment charges on bank stocks totaling $1,878,000 in the first nine months of 2008, including $458,000 in the third quarter. Table XII shows that, after the effects of the other-than-temporary impairment write-downs, the aggregate fair value of the Corporation s equity securities is $648,000 higher than cost. This net unrealized gain includes gross unrealized gains on stocks totaling $2,948,000, and gross unrealized losses on other stocks totaling $2,300,000. Table XII presents quantitative data concerning the effects of a decline in fair value of the Corporation s equity securities of 10% or 20%. The data in Table XII does not reflect the effects of any appreciation in value that may occur, nor does it present the Corporation s maximum exposure to loss on equity securities, which would be 100% of their value as of September 30, 2008.

Equity securities held as of September 30, 2008 and December 31, 2007 are presented in Table XII.

TABLE XII EQUITY SECURITIES
(In Thousands)

At September 30, 2008	**Cost**	**Fair Value**	**Hypothetical 10% Decline In Market Value**	**Hypothetical 20% Decline In Market Value**
Banks and bank holding companies	$18,411	$19,318	$(1,932)	$(3,864)
Other equity securities	2,798	2,539	(254)	(508)
Total	$21,209	$21,857	$(2,186)	$(4,372)

At December 31, 2007	**Cost**	**Fair Value**	**Hypothetical 10% Decline In Market Value**	**Hypothetical 20% Decline In Market Value**
Banks and bank holding companies	$19,868	$19,797	$(1,980)	$(3,959)
Other equity securities	2,577	2,950	(295)	(590)
Total	$22,445	$22,747	$(2,275)	$(4,549)

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 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.

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

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

As described in more detail in Note 5 to the consolidated financial statements, at September 30, 2008, the Corporation changed its method of valuing pooled trust-preferred securities from a Level 2 methodology (as defined in SFAS No. 157) that had been used in prior periods, based on price quotes received from pricing services, to a Level 3 methodology (as defined in SFAS No. 157), using discounted cash flows. Management estimated the cash flows a market participant would expect to receive 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 market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amounts calculated by management.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

The Corporation and the subsidiary banks 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

Except as described in the following paragraph, there have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation s Form 10-K filed February 29, 2008.

Pooled trust-preferred securities are long-term instruments, mainly issued by banks, with 30 or more companies included in each pool. In 2008, trading volume of pooled trust-preferred securities has become virtually nonexistent. Several of the Corporation s trust-preferred securities were downgraded by Moody s during the third quarter 2008, with five securities falling to ratings of less than investment grade. Further, Moody s and Fitch have placed all of the pooled trust-preferred securities on Ratings Watch Negative, meaning that an initial or further downgrade may be possible in the foreseeable future. In the first nine months of 2008, some of the issuers of trust-preferred securities that are included in the Corporation s pooled investments have elected to defer payment of interest on these obligations (trust-preferred securities typically permit deferral of quarterly interest payments for up to five years), and some issuers have defaulted. The Corporation recorded write-downs of the cost basis of three trust-preferred securities totaling $4,289,000 to their estimated fair values as of September 30, 2008. As of September 30, 2008, the Corporation s cost basis in pooled trust-preferred securities totaled $86.6 million, and the estimated fair value was $63.2 million. If the level of payment defaults by the underlying issuers of the pooled trust-preferred securities exceeds the amounts estimated by management in evaluating them for other-than-temporary impairment and calculating fair values at September 30, 2008, the Corporation would record additional other-than-temporary-impairment losses, and the amount of such losses could be significant.

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

c. Issuer Purchases of Equity Securities

On August 21, 2008, the Corporation announced the extension and amendment of a plan that permits the repurchase of shares of its outstanding common stock, up to an aggregate total of $10 million, through August 31, 2009. The Board of Directors authorized repurchase from time to time at prevailing market prices in open market or in privately negotiated transactions as, in management s sole opinion, market conditions warrant and based on stock availability, price and the Corporation s financial performance. As of September 30, 2008, the maximum additional value available for purchases under this program is $9,431,995. In the table below, the maximum dollar value amounts for July 2008 represent the amounts under the previous plan in effect until the plan amendment date.

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

The following table sets forth a summary of the purchases by the Corporation, on the open market, of its equity securities for the third quarter 2008:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
July 1 31, 2008	7,008	$ 20.89	7,008	$ 9,001,852
August 1 31, 2008	28,500	$ 19.93	35,508	$ 9,431,995

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q
Item 6. Exhibits

2.	Plan of acquisition, reorganization, arrangement, liquidation or succession	Not applicable
3.	(i) Articles of Incorporation	Incorporated by reference to Exhibit 4.1 to the Corporation s Form S-8 registration statement filed November 3, 2006
3.	(ii) By-laws	Incorporated by reference to Exhibit 3.1 of the Corporation s Form 8-K filed August 25, 2004
4.	Instruments defining the rights of security holders, including indentures	Not applicable
10.	Material contracts:	
	10.1 Form of Stock Option and Restricted Stock agreement dated January 3, 2008 between the Corporation and its independent directors pursuant to the Citizens & Northern Corporation Independent Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Corporation s Form 10-Q filed on May 6, 2008
	10.2 Form of Stock Option agreement dated January 3, 2008 between the Corporation and certain officers pursuant to the Citizens & Northern Corporation Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Corporation s Form 10-Q filed on May 6, 2008
	10.3 Form of Restricted Stock agreement dated January 3, 2008 between the Corporation and certain officers pursuant to the Citizens & Northern Corporation Stock Incentive Plan	Incorporated by reference to Exhibit 10.3 of the Corporation s Form 10-Q filed on May 6, 2008
11.	Statement re: computation of per share earnings	Information concerning the computation of earnings per share is provided in Note 2 to the Consolidated Financial Statements, which is included in Part I, Item 1 of Form 10-Q.
15.	Letter re: unaudited interim financial information	Not applicable
18.	Letter re: change in accounting principles	Not applicable
19.	Report furnished to security holders	Not applicable
22.	Published report regarding matters submitted to vote of security holders	Not applicable
23.	Consents of experts and counsel	Not applicable

24.	Power of attorney	Not applicable
31.	Rule 13a-14(a)/15d-14(a) certifications:	
	31.1 Certification of Chief Executive Officer	Filed herewith
	31.2 Certification of Chief Financial Officer	Filed herewith
32.	Section 1350 certifications	Filed herewith
99.	Additional exhibits:	Not applicable
100.	XBRL-related documents	Not applicable

Table of Contents

CITIZENS & NORTHERN CORPORATION FORM 10-Q

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
November 6, 2008	By: /s/ Craig G. Litchfield
Date	Chairman, President and Chief Executive Officer
November 6, 2008	By: /s/ Mark A. Hughes
Date	Treasurer and Chief Financial Officer

42