

CITIZENS & NORTHERN CORP

Form 10-Q

November 06, 2006

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

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from _____ to _____.

Commission file number: 000-16084

CITIZENS & NORTHERN CORPORATION

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA

23-2451943

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

90-92 MAIN STREET, WELLSBORO, PA

16901

(Address of principal executive offices)

(Zip code)

570-724-3411

(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to section 12(g) of the Act:

COMMON STOCK Par Value \$1.00

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Yes No

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

Common Stock (\$1.00 par value)

8,209,284 Shares Outstanding on October 26, 2006

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(In Thousands Except Share Data)

	September 30, 2006 (Unaudited)	December 31, 2005 (Note)
ASSETS		
Cash and due from banks:		
Noninterest-bearing	\$ 18,361	\$ 20,922
Interest-bearing	3,012	5,524
Total cash and cash equivalents	21,373	26,446
Available-for-sale securities	368,481	427,298
Held-to-maturity securities	417	422
Loans, net	668,348	644,938
Bank-owned life insurance	19,105	18,643
Accrued interest receivable	4,837	5,500
Bank premises and equipment, net	23,518	22,605
Foreclosed assets held for sale	276	194
Intangible Asset Core Deposit Intangible	368	464
Intangible Asset Goodwill	2,919	2,919
Other assets	15,645	13,525
TOTAL ASSETS	\$1,125,287	\$1,162,954
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 103,566	\$ 96,644
Interest-bearing	652,806	660,421
Total deposits	756,372	757,065
Dividends payable	1,970	1,973
Short-term borrowings	63,479	34,734
Long-term borrowings	168,470	232,205
Accrued interest and other liabilities	5,265	5,009
TOTAL LIABILITIES	995,556	1,030,986
STOCKHOLDERS EQUITY		
Common stock, par value \$1.00 per share; authorized 20,000,000 shares, issued 8,472,382 in 2006 and 8,389,418 in 2005	8,472	8,389
Stock dividend distributable		2,183
Paid-in capital	27,065	24,964
Retained earnings	97,074	93,728

Total	132,611	129,264
Accumulated other comprehensive income	1,300	4,698
Unamortized stock compensation	(19)	(50)
Treasury stock, at cost:		
263,518 shares at September 30, 2006	(4,161)	
168,627 shares at December 31, 2005		(1,944)
TOTAL STOCKHOLDERS EQUITY	129,731	131,968
TOTAL LIABILITIES & STOCKHOLDERS EQUITY	\$1,125,287	\$1,162,954

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

Note: The balance sheet at December 31, 2005 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.

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CITIZENS & NORTHERN CORPORATION FORM 10-Q
CONSOLIDATED STATEMENT OF INCOME
(In Thousands, Except Per Share Data) (Unaudited)

	3 Months Ended		Fiscal Year To Date	
	Sept. 30,	Sept. 30,	9 Months Ended Sept. 30,	2005
	2006	2005	2006	2005
	(Current)	(Prior Year)	(Current)	(Prior Year)
INTEREST INCOME				
Interest and fees on loans	\$ 11,046	\$ 10,003	\$ 31,907	\$ 28,327
Interest on balances with depository institutions	23	11	58	24
Interest on loans to political subdivisions	321	293	967	808
Interest on federal funds sold	146	31	242	61
Income from available-for-sale and held-to-maturity securities:				
Taxable	3,588	3,580	10,865	10,859
Tax-exempt	792	1,419	3,174	4,306
Dividends	236	234	786	787
Total interest and dividend income	16,152	15,571	47,999	45,172
INTEREST EXPENSE				
Interest on deposits	5,688	3,870	15,995	10,924
Interest on short-term borrowings	562	337	1,611	894
Interest on long-term borrowings	1,583	2,219	5,071	6,720
Total interest expense	7,833	6,426	22,677	18,538
Interest margin	8,319	9,145	25,322	26,634
Provision for loan losses	191	375	491	1,125
Interest margin after provision for loan losses	8,128	8,770	24,831	25,509
OTHER INCOME				
Service charges on deposit accounts	560	457	1,523	1,182
Service charges and fees	130	92	304	288
Trust and financial management revenue	726	539	1,784	1,589
Insurance commissions, fees and premiums	111	221	371	405
Increase in cash surrender value of life insurance	163	138	463	417
Fees related to credit card operation	509	212	602	602
Other operating income	509	490	1,480	1,258
Total other income before realized gains on securities, net	2,199	2,149	5,925	5,741

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Realized gains on securities, net	1,602	393	4,250	2,388
Total other income	3,801	2,542	10,175	8,129
OTHER EXPENSES				
Salaries and wages	3,425	3,249	10,111	9,172
Pensions and other employee benefits	1,003	893	3,151	2,878
Occupancy expense, net	560	451	1,734	1,376
Furniture and equipment expense	651	626	1,981	1,924
Pennsylvania shares tax	244	196	732	608
Other operating expense	1,757	1,888	5,750	5,646
Total other expenses	7,640	7,303	23,459	21,604
Income before income tax provision	4,289	4,009	11,547	12,034
Income tax provision	1,016	722	2,255	2,154
NET INCOME	\$ 3,273	\$ 3,287	\$ 9,292	\$ 9,880
PER SHARE DATA:				
Net income basic	\$ 0.40	\$ 0.40	\$ 1.12	\$ 1.19
Net income diluted	\$ 0.40	\$ 0.39	\$ 1.12	\$ 1.18
Dividend per share	\$ 0.24	\$ 0.23	\$ 0.72	\$ 0.69
Number of shares used in computation basic	8,240,036	8,297,519	8,272,449	8,288,502
Number of shares used in computation diluted	8,261,940	8,365,924	8,299,886	8,353,004

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

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CITIZENS & NORTHERN CORPORATION FORM 10-Q
Consolidated Statement of Cash Flows
(In Thousands)

	9 Months Ended	
	Sept. 30, 2006	Sept. 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 9,292	\$ 9,880
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	491	1,125
Realized gains on securities, net	(4,250)	(2,388)
Gain on sale of premises and equipment	(26)	
Gain on sale of foreclosed assets, net	(35)	(133)
Depreciation expense	1,942	1,687
Loss from writedown of impaired premises and equipment	169	
Accretion and amortization of securities, net	365	223
Increase in cash surrender value of life insurance	(463)	(417)
Amortization of restricted stock	31	69
Amortization of core deposit intangible	96	21
Increase in accrued interest receivable and other assets	(2,302)	(1,566)
Increase in accrued interest payable and other liabilities	1,165	2,952
Net Cash Provided by Operating Activities	6,475	11,453
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturity of held-to-maturity securities	4	7
Proceeds from sales of available-for-sale securities	93,402	134,919
Proceeds from calls and maturities of available-for-sale securities	26,200	45,117
Purchase of available-for-sale securities	(62,052)	(150,012)
Purchase of Federal Home Loan Bank of Pittsburgh stock	(1,597)	(3,883)
Redemption of Federal Home Loan Bank of Pittsburgh stock	3,289	5,390
Net increase in loans	(24,551)	(42,671)
Purchase of premises and equipment	(3,220)	(5,172)
Proceeds from sales of premises and equipment	222	
Proceeds from sale of foreclosed assets	603	791
Proceeds from acquisition of Canisteo Valley Corporation, net		202
Net Cash Provided by (Used in) Investing Activities	32,300	(15,313)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (decrease) increase in deposits	(693)	38,455
Net increase in short-term borrowings	28,745	7,627
Proceeds from long-term borrowings		18,163
Repayments of long-term borrowings	(63,735)	(42,491)
Purchase of treasury stock	(2,274)	(59)
Sale of treasury stock	76	652
Tax benefit from compensation plans	7	60

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Dividends paid	(5,974)	(5,667)
Net Cash (Used In) Provided by Financing Activities	(43,848)	16,740
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,073)	12,880
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	26,446	18,953
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 21,373	\$ 31,833

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CITIZENS & NORTHERN CORPORATION FORM 10-Q
Consolidated Statement of Cash Flows
(In Thousands) (Unaudited) (Continued)

	9 Months Ended	
	Sept. 30, 2006	Sept. 30, 2005
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Assets acquired through foreclosure of real estate loans	\$ 650	\$ 268
Interest paid	\$22,778	\$16,019
Income taxes paid	\$ 1,750	\$ 2,092
ACQUISITION OF CANISTEO VALLEY CORPORATION:		
Cash and cash equivalents received	\$	\$ 7,136
Cash paid for acquisition		(6,934)
Net cash received on acquisition	\$	\$ 202
NONCASH ASSETS RECEIVED AND LIABILITIES ASSUMED FROM ACQUISITION OF CANISTEO VALLEY CORPORATION:		
Assets received:		
Available for sale securities	\$	\$ 9,439
Loans		23,542
Premises and equipment		1,469
Foreclosed assets		46
Intangible asset core deposit intangible		547
Intangible asset goodwill		2,944
Other assets		446
Total noncash assets received	\$	\$38,433
Liabilities assumed:		
Deposits	\$	\$38,008
Other liabilities		627
Total noncash liabilities assumed	\$	\$38,635

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

Table of Contents**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, 2005, 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, 2006 might not be indicative of the results for the year ending December 31, 2006.

Certain merchant services revenue previously included in fees related to credit card operations has been reclassified to Other Operating Income. Merchant services revenue was \$59,000 and \$52,000 for the three months ended September 30, 2006 and 2005. Merchant services revenue was \$139,000 and \$110,000 for the nine months ended September 30, 2006 and 2005.

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 reflect the retroactive effect of stock dividends for all periods presented. The following data show 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, 2006			
Earnings per share - basic	\$9,292,000	8,272,449	\$1.12
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		139,968	
Hypothetical share repurchase at \$23.80		(112,531)	
Earnings per share - diluted	\$9,292,000	8,299,886	\$1.12
Nine Months Ended September 30, 2005			
Earnings per share - basic	\$9,880,000	8,288,502	\$1.19
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		215,283	
Hypothetical share repurchase at \$30.55		(150,781)	
Earnings per share - diluted	\$9,880,000	8,353,004	\$1.18

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	Net Income	Weighted- Average Common Shares	Earnings Per Share
Quarter Ended September 30, 2006			
Earnings per share basic	\$3,273,000	8,240,036	\$0.40
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		120,591	
Hypothetical share repurchase at \$22.53		(98,687)	
Earnings per share diluted	\$3,273,000	8,261,940	\$0.40
Quarter Ended September 30, 2005			
Earnings per share basic	\$3,287,000	8,297,519	\$0.40
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		211,805	
Hypothetical share repurchase at \$31.51		(143,400)	
Earnings per share diluted	\$3,287,000	8,365,924	\$0.39

3. STOCK COMPENSATION PLANS

Effective in the first quarter of 2006, the Financial Accounting Standards Board issued SFAS No. 123R, which replaces SFAS No. 123 and supersedes APB Opinion 25. SFAS No. 123R requires the Corporation to record stock option expense based on estimated fair value calculated using an option valuation model. The provisions of SFAS 123R must be applied to any new awards granted, and to any modifications of existing awards. Since the Corporation has neither modified, nor issued, any new options in 2006, and all options issued prior to December 31, 2005 are fully vested, the provisions of SFAS No. 123R have no impact on net income in 2006.

In previous years, the Corporation used the intrinsic value method of accounting for stock compensation plans, with compensation cost measured by the excess of the quoted market price of the stock as of the grant date (or other measurement date) over the amount an employee or director must pay to acquire the stock. Stock options issued under the Corporation's stock option plans have had no intrinsic value; therefore, no compensation cost was recorded for them.

The Corporation has also made prior awards of restricted stock. Compensation cost related to restricted stock has been recognized based on the market price of the stock at the grant date over the vesting period.

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The following table illustrates the effect on net income and earnings per share if the Corporation had applied the fair value provisions of SFAS No. 123 to stock options.

(Net Income in Thousands)

	3 Months Ended		9 Months Ended	
	Sept. 30,		Sept. 30,	
	2006	2005	2006	2005
Net income, as reported	\$3,273	\$3,287	\$9,292	\$9,880
Deduct: Total stock option compensation expense determined under fair value method for all awards, net of tax effects				(69)
Pro forma net income	\$3,273	\$3,287	\$9,292	\$9,811
Earnings per share-basic				
As reported	\$ 0.40	\$ 0.40	\$ 1.12	\$ 1.19
Pro forma	\$ 0.40	\$ 0.40	\$ 1.12	\$ 1.18
Earnings per share-diluted				
As reported	\$ 0.40	\$ 0.39	\$ 1.12	\$ 1.18
Pro forma	\$ 0.40	\$ 0.39	\$ 1.12	\$ 1.17

4. COMPREHENSIVE INCOME

U.S. generally accepted accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although unrealized gains and losses on available-for-sale securities are reported as a separate component of the equity section of the balance sheet, changes in unrealized gains and losses on available-for-sale securities, along with net income, are components of comprehensive income.

The components of comprehensive income, and the related tax effects, are as follows:

(In Thousands)

	3 Months Ended		9 Months Ended	
	Sept. 30,	Sept. 30,	Sept. 30,	Sept. 30,
	2006	2005	2006	2005
Net income	\$ 3,273	\$ 3,287	\$ 9,292	\$ 9,880
Unrealized holding gains (losses) on available-for-sale securities	3,707	(4,104)	(898)	(5,226)
Reclassification adjustment for gains realized in income	(1,602)	(393)	(4,250)	(2,388)
Other comprehensive income (loss) before income tax	2,105	(4,497)	(5,148)	(7,614)
Income tax related to other comprehensive income/loss	(716)	1,529	1,750	2,589
Other comprehensive income (loss)	1,389	(2,968)	(3,398)	(5,025)

Comprehensive income	\$ 4,662	\$ 319	\$ 5,894	\$ 4,855
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Table of Contents**CITIZENS & NORTHERN CORPORATION FORM 10-Q****5. SECURITIES**

Amortized cost and fair value of securities at September 30, 2006 are as follows:

(In Thousands)

	Amortized Cost	September 30, 2006		Fair Value
		Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of other U.S. Government agencies	\$ 33,000	\$	\$ (533)	\$ 32,467
Obligations of states and political subdivisions	71,897	859	(468)	72,288
Mortgage-backed securities	117,764	127	(3,143)	114,748
Other securities	120,930	661	(1,931)	119,660
Total debt securities	343,591	1,647	(6,075)	339,163
Marketable equity securities	22,929	6,654	(265)	29,318
Total	\$366,520	\$8,301	\$ (6,340)	\$368,481
HELD-TO-MATURITY SECURITIES:				
Obligations of the U.S. Treasury	\$ 311	\$ 6	\$	\$ 317
Obligations of other U.S. Government agencies	99	6		105
Mortgage-backed securities	7			7
Total	\$ 417	\$ 12	\$	\$ 429

The following table presents gross unrealized losses and fair value of investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2006.
(In Thousands)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
AVAILABLE-FOR-SALE SECURITIES:						
Obligations of other U.S. Government agencies	\$ 4,416	\$ (84)	\$ 28,051	\$ (449)	\$ 32,467	\$ (533)
Obligations of states and political subdivisions	13,918	(238)	14,722	(230)	28,640	(468)
Mortgage-backed securities	14,538	(138)	91,342	(3,005)	105,880	(3,143)
Other securities	40,292	(624)	48,674	(1,307)	88,966	(1,931)
Total debt securities	73,164	(1,084)	182,789	(4,991)	255,953	(6,075)
Marketable equity securities	2,609	(103)	1,296	(162)	3,905	(265)
	\$75,773	\$ (1,187)	\$184,085	\$ (5,153)	\$259,858	\$ (6,340)

Total temporarily impaired
available-for-sale securities

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns 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.

The unrealized losses on debt securities are primarily the result of volatility in interest rates. Based on the credit worthiness of the issuers, management believes the Corporation's debt securities at September 30, 2006 were not other-than-temporarily impaired.

Table of Contents**CITIZENS & NORTHERN CORPORATION FORM 10-Q****6. DEFINED BENEFIT PLANS**

The Corporation has a noncontributory defined benefit pension plan for all employees meeting certain age and length of service requirements. Benefits are based primarily on years of service and the average annual compensation during the highest five consecutive years.

In addition, 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, 2006 and December 31, 2005, and will not affect the Corporation's future expenses.

The Corporation uses a December 31 measurement date for its plans.

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

(In Thousands)

	Pension		Postretirement	
	Nine Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Service cost	\$ 457	\$ 356	\$ 48	\$ 35
Interest cost	472	464	46	50
Expected return on plan assets	(623)	(595)		
Amortization of transition (asset) obligation	(17)	(17)	27	27
Recognized net actuarial loss	59	29	2	2
Net periodic benefit cost	\$ 348	\$ 237	\$ 123	\$ 114

(In Thousands)

	Pension		Postretirement	
	Three Months Ended		Three Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Service cost	\$ 152	\$ 118	\$ 16	\$ 11
Interest cost	157	155	15	17
Expected return on plan assets	(207)	(198)		
Amortization of transition (asset) obligation	(5)	(5)	9	9
Recognized net actuarial loss	20	10	1	1
Net periodic benefit cost	\$ 117	\$ 80	\$ 41	\$ 38

In September 2006, the Corporation made its annual contribution to the defined benefit pension plan of \$640,000. For the nine months to date of 2006, the Corporation funded postretirement contributions totaling \$39,000, with estimated annual postretirement contributions of \$62,000 expected in 2006 for the full year.

7. CONTINGENCIES

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

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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 forward-looking statements are subject to risks and uncertainties that are difficult to predict, may be beyond management's control and could cause results to differ materially from those expressed or implied by such forward-looking statements. Factors which could have a material, adverse impact on the operations and future prospects of the Corporation include, but are not limited to, the following:

- changes in monetary and fiscal policies of the Federal Reserve Board and the U. S. Government, particularly related to changes in interest rates

- changes in general economic conditions

- legislative or regulatory changes

- downturn in demand for loan, deposit and other financial services in the Corporation's market area

- increased competition from other banks and non-bank providers of financial services

- technological changes and increased technology-related costs

- changes in accounting principles, or the application of generally accepted accounting principles.

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

REFERENCES TO 2006 AND 2005

Unless otherwise noted, all references to 2006 in the following discussion of operating results are intended to mean the nine months ended September 30, 2006, and similarly, references to 2005 relate to the nine months ended September 30, 2005.

EARNINGS OVERVIEW

On October 12, 2006, the Corporation issued a press release with its unaudited financial results for the three-month and nine-month periods ended September 30, 2006. The net income amounts for the third quarter and year-to-date 2006, as reported in this Form 10-Q, are \$15,000 higher than the amounts previously reported in the press release, due to correction of an immaterial error.

Net income in 2006 was \$9,292,000, or \$1.12 per share (basic and diluted). Net income per share in 2005 was \$1.19 (basic) and \$1.18 (diluted). Return on average assets was 1.09% in 2006, down from 1.16% in 2005. Return on average equity was 9.45% for 2006, as compared to 9.95% for the same period in 2005.

The most significant income statement changes between 2006 and 2005 were as follows:

- The net interest margin decreased \$1,312,000, or 4.9%, in 2006 as compared to 2005. The yield curve has remained flat or inverted throughout most of 2006, increasing the Corporation's cost of funds while limiting opportunities to earn a positive spread from maintaining borrowed funds and holding investment securities. Accordingly, the Corporation has sold securities and repaid borrowings throughout much of 2006. The balance of available-for-sale securities was \$58,817,000 lower at September 30, 2006 than December 31, 2005, and the

September 30, 2006 balance of total short-term and long-term borrowings was \$34,990,000 lower than the December 31, 2005 balance. Changes in the net interest margin are discussed in more detail later in Management's Discussion and Analysis.

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Noninterest expense increased \$1,855,000 (8.6%) in 2006 over 2005. Much of the increase in noninterest expense in 2006 has been attributable to operations and start-up costs in new markets, including the First State Bank offices (Canisteo and South Hornell) in New York State, and the Jersey Shore and Old Lycoming Township

offices in Pennsylvania. For the first nine months of 2006, direct noninterest expense from these new locations exceeded 2005 amounts by \$1,568,000. The other significant organizational change affecting the comparison of non-interest expense between 2006 and 2005 is the sale of the credit card portfolio that took place in the fourth quarter 2005. Total non-interest expense attributable to the credit card operation was \$741,000 in 2005. Additional discussion of Other Expenses is described in the Non-interest Expense section of Management's Discussion and Analysis.

The provision for loan losses was \$491,000 for 2006, down from \$1,125,000 in 2005. In the second quarter 2006, negotiations and workout of a few large, commercial loans were completed, resulting in charge-offs totaling approximately \$450,000 less than the estimated allowances that had been previously established.

Net realized gains from sales of securities amounted to \$4,250,000 in 2006, an increase of \$1,862,000 over 2005. Most of the gains realized in 2006 have been from sales of bank stocks.

Net income in the third quarter 2006 was \$3,273,000, or \$14,000 (0.4%) lower than third quarter 2005 net income, and \$74,000 (2.3%) higher than the second quarter 2006. The net interest margin totaled \$8,319,000 in the third quarter 2006, down 9.0% from the third quarter 2005, mainly because of the impact of rising short-term interest rates on C&N's cost of funds. Net securities gains for the third quarter 2006 amounted to \$1,602,000, or \$1,209,000 more than the corresponding amount in the third quarter 2005. The income tax provision in the third quarter 2006 was \$1,016,000, or 23.8% of pre-tax income, up from \$722,000 or 18.0% of pre-tax income for the third quarter 2005. The higher tax rate in 2006 resulted from management's decision to reduce the percentage of assets held in tax-exempt securities, in an effort to avoid or minimize payment of alternative minimum tax.

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

	Sept. 30, 2006	June 30, 2006	Mar. 31, 2006	Dec. 31, 2005	Sept. 30, 2005	June 30, 2005	Mar. 31, 2005
Interest income	\$16,152	\$15,984	\$15,863	\$15,936	\$15,571	\$14,908	\$14,693
Interest expense	7,833	7,566	7,278	7,149	6,426	6,155	5,957
Interest margin	8,319	8,418	8,585	8,787	9,145	8,753	8,736
Provision (credit) for loan losses	191	(300)	600	901	375	375	375
Interest margin after provision for loan losses	8,128	8,718	7,985	7,886	8,770	8,378	8,361
Other income	2,199	1,937	1,789	1,895	2,149	1,889	1,703
Securities gains (losses)	1,602	1,333	1,315	(586)	393	929	1,066
Gain from sale of credit card loans				1,906			
Other expenses	7,640	7,976	7,843	7,358	7,303	7,173	7,128

Income before income tax provision	4,289	4,012	3,246	3,743	4,009	4,023	4,002
Income tax provision	1,016	813	426	639	722	725	707
Net income	\$ 3,273	\$ 3,199	\$ 2,820	\$ 3,104	\$ 3,287	\$ 3,298	\$ 3,295
Net income per share basic	\$ 0.40	\$ 0.39	\$ 0.34	\$ 0.37	\$ 0.40	\$ 0.40	\$ 0.40
Net income per share diluted	\$ 0.40	\$ 0.39	\$ 0.34	\$ 0.37	\$ 0.39	\$ 0.39	\$ 0.39

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

Prospects for the Fourth Quarter 2006

The yield curve has been flat or slightly inverted (meaning there is little or no difference between short-term and long-term interest rates, or that short-term rates are higher than long-term rates) throughout much of 2005 and all of 2006 to date. In this type of interest rate environment, there is little opportunity for the Corporation to earn a positive spread between earnings on available-for-sale securities and interest costs associated with borrowings, and therefore, this type of yield

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curve is not favorable for the net interest margin. Unless the shape of the yield curve changes significantly, management expects to utilize cash flows from operations, and may sell some available-for-sale securities, to pay off borrowings as they mature in the fourth quarter 2006, effectively reducing total assets and liabilities. Management hopes to use earnings from

growth in loans, funded by deposits, to offset the anticipated reduction in net interest income associated with the lack of opportunity for a positive spread between earnings on securities and the interest costs on borrowings.

On November 30, 2005, the Corporation sold substantially its entire credit card portfolio, and recognized a gain of \$1.9 million. As part of the sale, the Corporation continued to provide servicing of these credit cards through May 18, 2006. The Corporation recorded a \$280,000 liability for the estimated direct costs of providing servicing, net of servicing fees to be received from the buyer. Also in 2005, the Corporation recorded an accrual of \$175,000 for estimated losses associated with credit card receivables sold with recourse. The \$1.9 million gain recorded in 2005 was net of the servicing and recourse liabilities. Through September 30, 2006, direct servicing costs, net of fees received, have totaled \$60,000, with a remaining liability balance for servicing of \$220,000. Losses charged against the recourse liability through September 30, 2006, have totaled \$58,000, with a remaining liability balance of \$117,000. The liabilities for servicing and recourse losses are included in accrued interest and other liabilities in the consolidated balance sheet. Management expects to pay for additional expenditures related to servicing the credit card portfolio, and for losses on receivables sold with recourse, over the remainder of 2006, with the total amount of the expenditures to be determined by mid-December 2006 (the Corporation's recourse obligation expires as of November 30, 2006). Management expects to record the difference between the total amount of the additional servicing expenditures and recourse losses, and the related liability balances, as a gain or loss in the fourth quarter 2006.

Another major variable that affects the Corporation's earnings is securities gains and losses, particularly from bank stocks and other equity securities. Management's decisions regarding sales of securities are based on a variety of factors, with the overall goal of maximizing portfolio return over a long-term horizon. It is difficult to predict, with much precision, the amount of net securities gains and losses that will be realized in the fourth quarter 2006.

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. The Corporation receives estimated fair values of debt securities from an independent valuation service, or from brokers. In developing these 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. The large majority of the Corporation's securities are classified as available-for-sale. Accordingly, these securities are carried at fair value on the consolidated balance sheet, with unrealized gains and losses excluded from earnings and reported separately through accumulated other comprehensive income (included in stockholders' equity).

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 2006 and 2005. 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.

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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 Tables.

The net interest margin, on a tax-equivalent basis, of \$27,198,000 in 2006 decreased \$1,820,000, or 6.3% from 2005. The volume/rate analysis in Table IV shows that the net interest margin fell \$2,995,000 in 2006 as a result of interest rate changes. The reduction in net interest income from higher rates reflects the Corporation's liability sensitive position, that is, deposits and borrowings reprice more quickly, on average, than the earning assets base of loans and available-for-sale securities. Table IV also shows that volume increases had the effect of increasing net interest income \$1,175,000 in 2006 compared to 2005, as an increased volume of loans generated higher interest income of \$2,454,000, and lower long-term borrowings decreased interest expense \$1,792,000, while lower available-for-sale securities decreased interest income \$2,318,000. As presented in Table III, the Interest Rate Spread (excess of average rate of return on interest-bearing assets over average cost of funds on interest-bearing liabilities) tightened to 2.93% in 2006, compared to 3.22% for the year ended December 31, 2005 and 3.29% for the first nine months of 2005.

INTEREST INCOME AND EARNING ASSETS

Interest income increased 4.9%, to \$49,875,000 in 2006 from \$47,556,000 in 2005. Interest and fees from loans increased \$3,800,000, or 12.9%, while income from available-for-sale securities decreased \$1,695,000, or 9.4%. As indicated in Table III, average available-for-sale securities in the first nine months of 2006 amounted to \$391,742,000, a decrease of 12.0% from the first nine months of 2005. Proceeds from sales and maturities of securities have been used, in part, to help fund the continued growth in loans. Also, since short-term interest rates have been rising faster than long-term rates, there have been few opportunities to purchase mortgage-backed securities or other bonds at spreads sufficient to justify the applicable interest rate risk. The average rate of return on available-for-sale securities of 5.55% for the first nine months of 2006 was higher than the 5.39% level in the first nine months of 2005, and the 5.35% rate for the year ended December 31, 2005. The higher average yield on available-for-sale securities is attributed, in part, to the sale of certain lower yielding securities in the fourth quarter 2005. Such lower yielding securities were acquired in 2003 and 2004, when market yields were lower than current conditions. In addition, increased holdings of adjustable rate trust preferred securities in 2005 and 2006 have contributed to the increased yield since the yield on these securities generally rises consistent with short-term rates. The average balance of gross loans increased 8.1% to \$657,447,000 for the first nine months of 2006 from \$607,981,000 in the first nine months of 2005. Since the Corporation acquired First State Bank on September 1, 2005, First State Bank's loans are included in the calculation of average loans throughout the nine months ended September 30, 2006, but are included for only one month of 2005. Excluding loans acquired from First State Bank, average loans increased 4.9%. The average rate of return on loans was 6.77% in the first nine months of 2006, as compared to 6.49% in first nine months of 2005, and 6.53% for the year 2005.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense rose \$4,139,000, or 22.3%, to \$22,677,000 in 2006 from \$18,538,000 in 2005. Table III reflects the current trend in interest rates incurred on liabilities, as the overall cost of funds on interest-bearing liabilities rose to 3.38% for the first nine months of 2006, from 2.81% for the year ended December 31, 2005, and 2.72% for the first nine months of 2005.

From Table III, you can calculate that total average deposits (interest-bearing and noninterest-bearing) increased to \$752,575,000 in the first nine months of 2006, or a 9.5% increase, from \$687,363,000 in the first nine months of 2005. The most significant increases in average deposits by categories were \$29,974,000 for interest checking accounts (74.4%), \$22,440,000 for certificates of deposit (11.7%), and \$17,541,000 (20.8%) for demand deposit accounts. Average money market account balances decreased \$10,230,000, or 5.4%, in the first nine months of 2006 as compared to the same period in 2005, as some depositors have moved balances to higher-rate certificates of deposit or withdrawn funds to invest in equities. Most of the increase in interest checking balances is attributable to one local governmental customer, for which the Corporation became the primary depository institution in September 2005. In addition, the

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acquisition of First State Bank contributed significantly to the increase in average deposits in 2006 compared to 2005. Excluding First State Bank, average total deposits increased 4.9% in 2006 compared to 2005.

The combined average total short-term and long-term borrowed funds decreased \$60,527,000 to \$246,069,000 in the first nine months of 2006 from \$306,596,000 in the first nine months of 2005. Throughout most of 2005 and 2006, the yield curve has been flat or inverted, limiting opportunities for the Corporation to earn a positive spread over interest costs associated with maintaining borrowed funds. Accordingly, the Corporation has been paying off borrowings as they mature, or rolling them over at terms of less than one year. The pace of such changes or trends is reflected in the Corporation's consolidated balance sheet, as total short-term borrowings increased to \$63,479,000 at September 30, 2006 from \$34,734,000 at December 31, 2005, while total long-term borrowings decreased to \$168,470,000 at September 30, 2006 from \$232,205,000 at December 31, 2005.

TABLE II ANALYSIS OF INTEREST INCOME AND EXPENSE**(In Thousands)**

	Nine Months Ended		
	September 30,		
	2006	2005	Increase/ (Decrease)
INTEREST INCOME			
Available-for-sale securities:			
Taxable	\$11,633	\$11,627	\$ 6
Tax-exempt	4,614	6,315	(1,701)
Total available-for-sale securities	16,247	17,942	(1,695)
Held-to-maturity securities, Taxable	18	19	(1)
Interest-bearing due from banks	58	24	34
Federal funds sold	242	61	181
Loans:			
Taxable	31,907	28,327	3,580
Tax-exempt	1,403	1,183	220
Total loans	33,310	29,510	3,800
Total Interest Income	49,875	47,556	2,319
INTEREST EXPENSE			
Interest checking	1,378	218	1,160
Money market	4,340	2,812	1,528
Savings	257	218	39
Certificates of deposit	6,187	4,576	1,611
Individual Retirement Accounts	3,827	3,095	732
Other time deposits	6	5	1
Short-term borrowings	1,611	894	717
Long-term borrowings	5,071	6,720	(1,649)
Total Interest Expense	22,677	18,538	4,139

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Net Interest Income	\$27,198	\$29,018	\$(1,820)
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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 9/30/2006 Average Balance	Rate of Return/ Cost of Funds %	Year Ended 12/31/2005 Average Balance	Rate of Return/ Cost of Funds %	9 Months Ended 9/30/2005 Average Balance	Rate of Return/ Cost of Funds %
EARNING ASSETS						
Available-for-sale securities, at amortized cost:						
Taxable	\$ 296,774	5.24%	\$ 319,230	4.83%	\$ 323,544	4.80%
Tax-exempt	94,968	6.50%	123,295	6.72%	121,618	6.94%
Total available-for-sale securities	391,742	5.55%	442,525	5.35%	445,162	5.39%
Held-to-maturity securities,						
Taxable	419	5.74%	427	5.85%	429	5.92%
Interest-bearing due from banks	2,066	3.75%	1,293	2.63%	1,355	2.37%
Federal funds sold	5,763	5.61%	2,600	3.73%	2,698	3.02%
Loans:						
Taxable	627,102	6.80%	592,227	6.55%	582,967	6.50%
Tax-exempt	30,345	6.18%	26,117	6.25%	25,014	6.32%
Total loans	657,447	6.77%	618,344	6.53%	607,981	6.49%
Total Earning Assets	1,057,437	6.31%	1,065,189	6.03%	1,057,625	6.01%
Cash	19,309		9,014		9,077	
Unrealized gain/loss on securities	3,385		11,197		12,823	
Allowance for loan losses	(8,589)		(7,297)		(7,100)	
Bank premises and equipment	23,517		19,247		18,214	
Intangible Asset Core						
Deposit Intangible	402		169			
Intangible Asset Goodwill	2,919		983			
Other assets	39,165		46,117		45,793	
Total Assets	\$1,137,545		\$1,144,619		\$1,136,432	
INTEREST-BEARING LIABILITIES						
Interest checking	\$ 70,275	2.62%	\$ 46,408	1.15%	\$ 40,301	0.72%

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Money market	180,001	3.22%	188,507	2.20%	190,231	1.98%
Savings	63,072	0.54%	60,203	0.50%	58,431	0.50%
Certificates of deposit	213,792	3.87%	197,165	3.26%	191,352	3.20%
Individual Retirement						
Accounts	122,491	4.18%	121,013	3.46%	121,606	3.40%
Other time deposits	1,256	0.64%	1,152	0.52%	1,295	0.52%
Short-term borrowings	54,275	3.97%	44,267	2.80%	46,930	2.55%
Long-term borrowings	191,794	3.53%	254,987	3.47%	259,666	3.46%
Total Interest-bearing						
Liabilities	896,956	3.38%	913,702	2.81%	909,812	2.72%
Demand deposits	101,688		87,956		84,147	
Other liabilities	7,806		10,496		10,117	
Total Liabilities	1,006,450		1,012,154		1,004,076	
Stockholders equity,						
excluding other						
comprehensive income/loss	128,856		125,076		124,090	
Other comprehensive						
income/loss	2,239		7,389		8,266	
Total Stockholders Equity	131,095		132,465		132,356	
Total Liabilities and						
Stockholders Equity	\$1,137,545		\$1,144,619		\$1,136,432	
Interest Rate Spread		2.93%		3.22%		3.29%
Net Interest						
Income/Earning Assets		3.44%		3.62%		3.67%

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

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

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TABLE IV ANALYSIS OF VOLUME AND RATE CHANGES
(In Thousands)

	YTD Ended 9/30/06 vs. 9/30/05		Total Change
	Change in Volume	Change in Rate	
EARNING ASSETS			
Available-for-sale securities:			
Taxable	\$ (1,003)	\$ 1,009	\$ 6
Tax-exempt	(1,315)	(386)	(1,701)
Total available-for-sale securities	(2,318)	623	(1,695)