CITIZENS & NORTHERN CORP
Form 10-Q
May 05, 2006

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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended March 31, 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 [X] 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 [X]   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 [X]

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

Common Stock ($1.00 par value)   8,277,769 Shares Outstanding on May 1, 2006

CITIZENS & NORTHERN CORPORATION - FORM 10-Q

Index

CITIZENS & NORTHERN CORPORATION - FORM 10-Q
ITEM 1. FINANCIAL STATEMENTS
CONSOLIDATED BALANCE SHEET
(In Thousands Except Share Data)

	MARCH 31, 2006 (UNAUDITED)	DECEMBER 3 2005 (NOTE)
ASSETS		
Cash and due from banks:		
Non-interest-bearing	$ 18,993	$ 20,92
Interest-bearing	2,469	5,52
Total cash and cash equivalents	21,462	26,44
Available-for-sale securities	427,975	427,29
Held-to-maturity securities	420	42
Loans, net	644,071	644,93
Bank-owned life insurance	18,790	18,64
Accrued interest receivable	5,382	5,50
Bank premises and equipment, net	23,652	22,60
Foreclosed assets held for sale	317	19
Intangible Asset - Core Deposit Intangible	402	46
Intangible Asset - Goodwill	2,919	2,91
Other assets	15,254	13,52
TOTAL ASSETS	$1,160,644	$1,162,95
LIABILITIES		
Deposits:		
Non-interest-bearing	$ 102,077	$ 96,64
Interest-bearing	650,637	660,42
Total deposits	752,714	757,06
Dividends payable	1,989	1,97
Short-term borrowings	74,514	34,73
Long-term borrowings	195,089	232,20
Accrued interest and other liabilities	6,290	5,00
TOTAL LIABILITIES	1,030,596	1,030,98
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	8,38
Stock dividend distributable	--	2,18
Paid-in capital	27,053	24,96
Retained earnings	94,562	93,72
Total	130,087	129,26
Accumulated other comprehensive income	2,332	4,69
Unamortized stock compensation	(40)	(5
Treasury stock, at cost:		
184,613 shares at March 31, 2006	(2,331)	
168,627 shares at December 31, 2005		(1,94
TOTAL STOCKHOLDERS' EQUITY	130,048	131,96
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	$1,160,644	$1,162,95

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.

CITIZENS & NORTHERN CORPORATION - FORM 10-Q
CONSOLIDATED STATEMENT OF INCOME
(IN THOUSANDS, EXCEPT PER SHARE DATA) (UNAUDITED)

	3 MONTHS ENDED MARCH 31, 2006	3 MONTHS ENDED MARCH 31, 2005
INTEREST INCOME		
Interest and fees on loans	$ 10,166	$ 9,006
Interest on balances with depository institutions	12	4
Interest on loans to political subdivisions	311	247
Interest on federal funds sold	43	8
Income from available-for-sale and held-to-maturity securities:		
Taxable	3,727	3,661
Tax-exempt	1,336	1,472
Dividends	268	295
Total interest and dividend income	15,863	14,693
INTEREST EXPENSE		
Interest on deposits	5,009	3,426
Interest on short-term borrowings	426	225
Interest on long-term borrowings	1,843	2,306
Total interest expense	7,278	5,957
Interest margin	8,585	8,736
Provision for loan losses	600	375
Interest margin after provision for loan losses	7,985	8,361
OTHER INCOME		
Service charges on deposit accounts	450	342
Service charges and fees	65	87
Trust and financial management revenue	511	479
Insurance commissions, fees and premiums	139	98
Increase in cash surrender value of life insurance	147	139
Fees related to credit card operation	--	187
Other operating income	477	371
Total other income before realized gains on securities, net	1,789	1,703
Realized gains on securities, net	1,315	1,066
Total other income	3,104	2,769
OTHER EXPENSES		
Salaries and wages	3,322	2,875
Pensions and other employee benefits	1,143	1,032
Occupancy expense, net	546	464

Furniture and equipment expense	650	648
Pennsylvania shares tax	244	215
Other operating expense	1,938	1,894
Total other expenses	7,843	7,128
Income before income tax provision	3,246	4,002
Income tax provision	426	707
NET INCOME	$ 2,820	$ 3,295
PER SHARE DATA:		
Net income - basic	$ 0.34	$ 0.40
Net income - diluted	$ 0.34	$ 0.39
Dividend per share	$ 0.24	$ 0.23
Number of shares used in computation - basic	8,296,922	8,275,172
Number of shares used in computation - diluted	8,335,009	8,346,220

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

CITIZENS & NORTHERN CORPORATION - FORM 10-Q
CONSOLIDATED STATEMENT OF CASH FLOWS
(IN THOUSANDS)

	3 MONTHS ENDED	
	MARCH 31, 2006	MARCH 31, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 2,820	$ 3,295
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	600	375
Realized gains on securities, net	(1,315)	(1,066)
Gain on sale of foreclosed assets, net	(14)	(50)
Depreciation expense	605	548
Accretion and amortization of securities, net	86	67
Increase in cash surrender value of life insurance	(147)	(139)
Amortization of restricted stock	10	21
Amortization of core deposit intangible	62	--
Increase in accrued interest receivable and other assets	(2,472)	(2,444)
Increase in accrued interest payable and other liabilities	2,529	1,151
Net Cash Provided by Operating Activities	2,764	1,758
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturity of held-to-maturity securities	2	3
Proceeds from sales of available-for-sale securities	10,566	31,488
Proceeds from calls and maturities of available-for-sale securities	8,291	18,204
Purchase of available-for-sale securities	(21,893)	(45,628)

Purchase of Federal Home Loan Bank of Pittsburgh stock	(327)	(1,832)
Redemption of Federal Home Loan Bank of Pittsburgh stock	1,162	1,902
Net decrease (increase) in loans	126	(19,832)
Purchase of premises and equipment	(1,652)	(953)
Proceeds from sale of foreclosed assets	32	59
Net Cash Used in Investing Activities	(3,693)	(16,589)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (decrease) increase in deposits	(4,351)	8,074
Net increase in short-term borrowings	39,780	15,989
Proceeds from long-term borrowings	--	13,000
Repayments of long-term borrowings	(37,116)	(26,433)
Purchase of treasury stock	(409)	--
Sale of treasury stock	29	423
Tax benefit from compensation plans	7	--
Dividends paid	(1,995)	(1,890)
Net Cash (Used In) Provided by Financing Activities	(4,055)	9,163
DECREASE IN CASH AND CASH EQUIVALENTS	(4,984)	(5,668)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	26,446	18,953
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 21,462	$ 13,285
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Assets acquired through foreclosure of real estate loans	$ 141	$ 165
Interest paid	$ 6,184	$ 5,421
Income taxes paid	$ --	$ 420

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

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 months ended March 31, 2006 might not be indicative of the results for the year ending December 31, 2006.

Certain merchant income previously included in fees related to credit card operation has been reclassified to Other Operating Income. Merchant income was $35,000 and $23,000 for the quarters ended March 31, 2006 and 2005, respectively.

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
QUARTER ENDED MARCH 31, 2006			
Earnings per share - basic	$2,820,000	8,296,922	$0.34
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		141,849	
Hypothetical share repurchase at $26.21		(103,762)	
Earnings per share - diluted	$2,820,000	8,335,009	$0.34
QUARTER ENDED MARCH 31, 2005			
Earnings per share - basic	$3,295,000	8,275,172	$0.40
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		241,417	
Hypothetical share repurchase at $29.99		(170,369)	
Earnings per share - diluted	$3,295,000	8,346,220	$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, the provisions of SFAS No. 123R have no current reporting implications.

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.

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.

	3 MONTHS ENDED	
	MARCH 31, 2006	MARCH 31, 2005
Net income, as reported	$2,820	$3,295
Deduct: Total stock option compensation expense determined under fair value method for all awards, net of tax effects	--	(35)
Pro forma net income	$2,820	$3,260
Earnings per share-basic		
As reported	$ 0.34	$ 0.40
Pro forma	$ 0.34	$ 0.39
Earnings per share-diluted		
As reported	$ 0.34	$ 0.39
Pro forma	$ 0.34	$ 0.39

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:

	3 MONTHS ENDED MARCH 31,	
(IN THOUSANDS)	2006	2005

Net income	$ 2,820	$ 3,295
Unrealized holding losses on available-for-sale securities	(2,265)	(5,881)
Less: Reclassification adjustment for gains realized in income	(1,315)	(1,066)
Other comprehensive loss before income tax	(3,580)	(6,947)
Income tax related to other comprehensive loss	1,214	2,362
Other comprehensive loss	(2,366)	(4,585)
Comprehensive income (loss)	$ 454	$(1,290)

5. SECURITIES

Amortized cost and fair value of securities at March 31, 2006 are summarized as follows:

(IN THOUSANDS)	MARCH 31, 2006 AMORTIZED COST	GROSS UNREALIZED HOLDING GAINS	GROSS UNREALIZED HOLDING LOSSES	FAIR VALUE
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of the U.S. Treasury	$ 500	$ --	$ (1)	$ 499
Obligations of other U.S. Government agencies	44,000	--	(1,161)	42,839
Obligations of states and political subdivisions	118,951	2,054	(1,624)	119,381
Other securities	108,519	1,046	(1,838)	107,727
Mortgage-backed securities	129,350	103	(4,039)	125,414
Total debt securities	401,320	3,203	(8,663)	395,860
Marketable equity securities	23,122	9,165	(172)	32,115
Total	$424,442	$12,368	$(8,835)	$427,975
HELD-TO-MATURITY SECURITIES:				
Obligations of the U.S. Treasury	$ 313	$ 13	$ --	$ 326
Obligations of other U.S. Government agencies	98	9	--	107
Mortgage-backed securities	9	--	--	9
Total	$ 420	$ 22	$ --	$ 442

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 March 31, 2006.

(IN THOUSANDS)	LESS THAN 12 MONTHS FAIR VALUE	LESS THAN 12 MONTHS UNREALIZED LOSSES	12 MONTHS OR MORE FAIR VALUE	12 MONTHS OR MORE UNREALIZED LOSSES
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of the U.S. Treasury	$ 500	$ (1)	$ --	$ --
Obligations of other U.S. Government agencies	33,207	(792)	9,632	(369)
Obligations of states and political subdivisions	53,595	(1,062)	7,991	(562)
Other securities	40,121	(518)	29,974	(1,320)
Mortgage-backed securities	31,912	(658)	87,774	(3,381)
Total debt securities	159,335	(3,031)	135,371	(5,632)
Marketable equity securities	1,264	(44)	1,213	(128)
Total temporarily impaired available-for-sale securities	$160,599	$(3,075)	$136,584	$(5,760)

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, which are almost exclusively U.S. Government agencies or state and political subdivisions, management believes the Corporation's debt securities at March 31, 2006 were not other-than-temporarily impaired.

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 March 31, 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 THREE MONTHS ENDED MARCH 31,	POSTRETIREMENT THREE MONTHS ENDED MARCH 31,

	2006	2005	2006	2005
Service cost	$ 152	$ 119	$16	$12
Interest cost	157	155	15	17
Expected return on plan assets	(208)	(198)	0	0
Amortization of transition (asset) obligation	(6)	(6)	9	9
Recognized net actuarial loss (gain)	20	10	1	1
Net periodic benefit cost (benefit)	$ 115	$ 80	$41	$39

For 2006, the minimum funding requirement for the defined benefit pension plan is $379,000; however, the Board of Directors authorized funding, in April 2006, up to the maximum funding limit of $640,000. In the first quarter of 2006, the Corporation funded postretirement contributions totaling $13,000, 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.

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 three months ended March 31, 2006, and similarly, references to "2005" relate to the three months ended March 31, 2005.

EARNINGS OVERVIEW

Net income in 2006 was $2,820,000, or $.34 per share - basic and diluted, which represents a decrease of 14.4% in net income compared to 2005. Return on average assets was .97% in 2006, as compared to 1.17% in 2005. Return on average equity was 8.51% for 2006, as compared to 9.87% in 2005.

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

- The net interest margin was $8,585,000 in 2006, a decrease of $151,000, or 1.7%, from $8,736,000 in 2005. Despite growth in both loans and deposits, the decrease in Net Interest Margin is attributed primarily to increases in short-term interest rates, compared to relatively flat long-term rates associated with the loan portfolio. Changes in the net interest margin are discussed in more detail later in Management's Discussion and Analysis.

- Other (non-interest) expenses increased $715,000, or 10.0%, in 2006 compared to 2005. For the first quarter of 2006, a major portion, or $627,000, of the total increase related to operations and start-up costs in new markets. New branch operations include First State Bank, our Jersey Shore office (opened August 2005), as well as our Old Lycoming Township branch and new Administrative office, both opened in March 2006. 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 $600,000 in the first quarter of 2006, with an increase of $225,000 compared to the same period in 2005. The additional loan loss provision was primarily associated with estimates of possible future charge-offs on certain large commercial loans.

- Net realized gains on securities were $1,315,000 in the first quarter of 2006, an increase of $249,000, compared to $1,066,000 in 2005. Sales of bank stocks provided most of the gains realized in 2006.

- The income tax provision decreased to $426,000, or 13.1% of pre-tax earnings, from $707,000, or 17.7% of pre-tax earnings in 2005. The lower effective tax rate results from the higher ratio of tax-exempt earnings based on the lower level of total pre-tax earnings.

TABLE I - QUARTERLY FINANCIAL DATA

(IN THOUSANDS)	MAR. 31, 2006	DEC. 31, 2005	SEPT. 30, 2005	JUNE 30, 2005	MA
Interest income	$15,863	$15,936	$15,571	$14,908	$
Interest expense	7,278	7,149	6,426	6,155	
Interest margin	8,585	8,787	9,145	8,753	
Provision for loan losses	600	901	375	375	
Interest margin after provision for loan losses	7,985	7,886	8,770	8,378	
Other income	1,789	1,895	2,149	1,889	
Securities gains (losses)	1,315	(586)	393	929	
Gain from sale of credit card loans	--	1,906	--	--	
Other expenses	7,843	7,358	7,303	7,173	
Income before income tax provision	3,246	3,743	4,009	4,023	
Income tax provision	426	639	722	725	
Net income	$ 2,820	$ 3,104	$ 3,287	$ 3,298	$
Net income per share - basic	$ 0.34	$ 0.37	$ 0.40	$ 0.40	$
Net income per share - diluted	$ 0.34	$ 0.37	$ 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 REMAINDER OF 2006

Management expects 2006 to be a year for building on the capital investments of 2005 by developing market presence in our new markets. The opening of 2 new branches in Jersey Shore (Fall 2005) and Old Lycoming Township (March 2006) provide growth opportunities in the Williamsport and surrounding Lycoming County market, especially for expansion of commercial lending relationships. The August 2005 acquisition of Canisteo Valley Corporation, including the branches of First State Bank, opens a variety of opportunities for growth and market development along the northern border of our current market operations. Also, in late February 2006, a new administrative facility opened, which provides ample space for key operating support functions, and additional space needed for customer contact personnel in our Wellsboro branch.

Currently, management expects the yield curve to continue to be nearly flat for most of 2006. Based on current trends for both short-term and long-term borrowing rates, management may compress the balance sheet by selling certain available-for-sale debt securities to pay off borrowings as they mature in 2006. Management hopes to use earnings from the expected growth in loans and 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.

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 throughout the remainder of 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. 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 $9,338,000 in 2006 decreased $208,000, or 2.2% from 2005. As reflected in Table IV, interest rate changes had the most significant impact on net interest margin with reductions of $774,000 in the net interest margin compared to 2005. 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 earnings assets base of loans and available-for-sale securities. Table IV also shows that volume increases had the effect of increasing net interest income of $566,000 in 2006 compared to 2005, and was primarily attributed to increased volume of loans. 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 3.05% compared to 3.22% for the year ended December 31, 2005 and 3.32% for the first quarter 2005.

INTEREST INCOME AND EARNING ASSETS

Interest income increased 7.2%, to $16,616,000 in 2006 from $15,503,000 in 2005. Interest and fees from loans increased $1,250,000, or 13.3%, while income from available-for-sale securities decreased $180,000, or 2.9%.

As indicated in Table III, average available-for-sale securities in the first quarter 2006 amounted to $419,690,000, a decrease of 7.6% from the first quarter 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 5.74% for the first quarter 2006 was higher than the 5.46% level in the first quarter 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 fourth quarter 2005 sale of certain lower yielding securities 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 8.8% to $648,872,000 for the first quarter of 2006 from $596,513,000 in the first quarter 2005. The acquisition of First State Bank in the third quarter of 2005 provided $21,903,000 of the growth in average gross loans compared to the previous year. The most significant growth was in commercial loans, due in part to the growth in staffing, especially new personnel and relationships in Williamsport and throughout Lycoming County, as well as an increased emphasis on commercial lending throughout the Corporation's market area over the last few years. The average rate of return on loans was 6.64% in the first quarter of 2006, as compared to

6.37% in first quarter of 2005, and 6.53% for the year 2005.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense rose $1,321,000, or 22.2%, to $7,278,000 in 2006 from $5,957,000 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 3.22% for the first quarter of 2006, from 2.81% for the year ended December 31, 2005, and 2.65% for the first quarter 2005. In addition, Table III shows the impact of rising short-term interest rates, by category, on the Corporation's primary sources of funds: (1) money market accounts, which increased to an average rate of 3.08% in 2006 compared to 1.82% in 2005, (2) interest checking accounts, which increased to an average rate of 2.53% from ..63%, (3) certificates of deposit, which increased to an average rate of 3.56% from 3.07%, (4) short-term borrowings, which rose to an average rate of 3.57% from 2.08%. The average rate incurred on long-term borrowings remained substantially unchanged, and reflects the replacement of such borrowings with either short-term instruments or repayment using the proceeds from the available-for-sale securities portfolio.

From Table III, you can calculate that total average deposits (interest-bearing and noninterest-bearing) increased to $749,104,000 in the first three months of 2006, or an 11.6% increase, from $671,165,000 in 2005. The increase in the average deposit balances for the first quarter of each year has been significantly impacted by fluctuations in deposits from municipal and non-profit customers. In addition, the acquisition of First State Bank provided an increase in average deposits of $26,453,000 in 2006 compared to 2005. The most significant increases in average deposits by categories were $35,676,000 for certificates of deposit (19.8%), $35,254,000 for interest checking accounts (94.6%), $20,016,000 (26.3%) for demand deposit accounts. 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.

The combined average total short-term and long-term borrowed funds decreased $52,436,000 to $263,347,000 in the first quarter 2006 from $315,783,000 in the first quarter 2005. Since the first quarter 2005, management's objective has been to use proceeds from the securities portfolio to help fund loan growth, has stabilized total borrowings to control the amount of growth in interest expense, and has converted maturing long-term borrowings into overnight or short-term borrowings. The growth of deposits, especially from new markets, has helped management efforts to reduce the impact of interest rate fluctuations. The pace of such changes or trends is reflected in the Corporation's consolidated balance sheet, as total short-term borrowings increased to $74,514,000 at March 31, 2006 from $34,734,000 at December 31, 2005, while total long-term borrowings decreased to $195,089,000 at March 31, 2006 from $232,205,000 at December 31, 2005.

TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE

(IN THOUSANDS)	THREE MONTHS ENDED MARCH 31, 2006	2005	INCREASE/ (DECREASE)
INTEREST INCOME			
Available-for-sale securities:			
Taxable	3,989	3,950	39
Tax-exempt	1,949	2,168	(219)
Total available-for-sale securities	5,938	6,118	(180)
Held-to-maturity securities,			
Taxable	6	6	--
Interest-bearing due from banks	12	4	8
Federal funds sold	43	8	35
Loans:			
Taxable	10,166	9,006	1,160
Tax-exempt	451	361	90
Total loans	10,617	9,367	1,250
Total Interest Income	16,616	15,503	1,113
INTEREST EXPENSE			
Interest checking	452	58	394
Money market	1,362	887	475
Savings	87	70	17
Certificates of deposit	1,900	1,365	535
Individual Retirement Accounts	1,207	1,045	162
Other time deposits	1	1	--
Short-term borrowings	426	225	201
Long-term borrowings	1,843	2,306	(463)
Total Interest Expense	7,278	5,957	1,321
Net Interest Income	$ 9,338	$ 9,546	$ (208)

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 III - ANALYSIS OF AVERAGE DAILY BALANCES AND RATES

	3 MONTHS ENDED 3/31/2006	RATE OF RETURN/	YEAR ENDED 12/31/2005	RATE OF RETURN/	3 3

(DOLLARS IN THOUSANDS)	AVERAGE BALANCE	COST OF FUNDS %	AVERAGE BALANCE	COST OF FUNDS %	
EARNING ASSETS					
Available-for-sale securities, at amortized cost:					
Taxable	$ 302,330	5.35%	$ 319,230	4.83%	$
Tax-exempt	117,360	6.74%	123,295	6.72%	
Total available-for-sale securities	419,690	5.74%	442,525	5.35%	
Held-to-maturity securities,					
Taxable	421	5.78%	427	5.85%	
Interest-bearing due from banks	1,430	3.40%	1,293	2.63%	
Federal funds sold	3,633	4.80%	2,600	3.73%	
Loans,					
Taxable	618,331	6.67%	592,227	6.55%	
Tax-exempt	30,541	5.99%	26,117	6.25%	
Total loans	648,872	6.64%	618,344	6.53%	
Total Earning Assets	1,074,046	6.27%	1,065,189	6.03%	1
Cash	10,311		9,014		
Unrealized gain/loss on securities	7,368		11,197		
Allowance for loan losses	(8,540)		(7,297)		
Bank premises and equipment	23,385		19,247		
Intangible Asset - Core Deposit Intangible	433		169		
Intangible Asset - Goodwill	2,919		983		
Other assets	43,281		46,117		
Total Assets	$1,153,203		$1,144,619		$1
INTEREST-BEARING LIABILITIES					
Interest checking	$ 72,530	2.53%	$ 46,408	1.15%	
Money market	179,348	3.08%	188,507	2.20%	
Savings	63,809	0.55%	60,203	0.50%	
Certificates of deposit	216,186	3.56%	197,165	3.26%	
Individual Retirement Accounts	120,174	4.07%	121,013	3.46%	
Other time deposits	908	0.45%	1,152	0.52%	
Short-term borrowing	48,384	3.57%	44,267	2.80%	
Long-term borrowing	214,963	3.48%	254,987	3.47%	
Total Interest-bearing Liabilities	916,302	3.22%	913,702	2.81%	
Demand deposits	96,149		87,956		
Other liabilities	8,143		10,496		
Total Liabilities	1,020,594		1,012,154		
Stockholders' equity, excluding other comprehensive income/loss	128,173		125,076		
Other comprehensive income/loss	4,436		7,389		
Total Stockholders' Equity	132,609		132,465		
Total Liabilities and Stockholders' Equity	$1,153,203		$1,144,619		$1
Interest Rate Spread		3.05%		3.22%	
Net Interest Income/Earning Assets		3.53%		3.62%	

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

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

TABLE IV - ANALYSIS OF VOLUME AND RATE CHANGES

	YTD ENDED 3/31/06 VS. 3/31/05		
(IN THOUSANDS)	CHANGE IN VOLUME	CHANGE IN RATE	TOTAL CHANGE
EARNING ASSETS			
Available-for-sale securities:			
Taxable	$(370)	$ 409	$ 39
Tax-exempt	(90)	(129)	(219)
Total available-for-sale securities	(460)	280	(180)
Held-to-maturity securities,			
Taxable	--	--	--
Interest-bearing due from banks	4	4	8
Federal funds sold	18	17	35
Loans:			
Taxable	731	429	1,160
Tax-exempt	107	(17)	90
Total loans	838	412	1,250
Total Interest Income	400	713	1,113
INTEREST-BEARING LIABILITIES			
Interest checking	95	299	394
Money market	(90)	565	475
Savings	9	8	17
Certificates of deposit	294	241	535
Individual Retirement Accounts	(11)	173	162
Other time deposits	--	--	--
Short-term borrowings	26	175	201
Long-term borrowings	(489)	26	(463)
Total Interest Expense	(166)	1,487	1,321
Net Interest Income	$ 566	$ (774)	$ (208)

(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 V - COMPARISON OF NON-INTEREST INCOME

	3 MONTHS ENDED	
(IN THOUSANDS)	MARCH 31, 2006	MARCH 31, 2005
Service charges on deposit accounts	$ 450	$ 342
Service charges and fees	65	87
Trust and financial management revenue	511	479
Insurance commissions, fees and premiums	139	98
Increase in cash surrender value of life insurance	147	139
Fees related to credit card operation	--	187
Other operating income	477	371
Total other operating income, before realized gains on securities, net	1,789	1,703
Realized gains on securities, net	1,315	1,066
Total Other Income	$3,104	$2,769

Total non-interest income increased $335,000, or 12.1%, in 2006 compared to 2005, primarily related to an increase in net realized gains on securities of $249,000. Securities gains are discussed in the Earnings Overview section of Management's Discussion and Analysis. Other items of significance are as follows:

- Service charges on deposit accounts increased $108,000, or 31.6%, in 2006 as compared to 2005. Overdraft charges represent the primary increase year over year with $87,000, of which $17,000 represents overdraft charges to customers of First State Bank. The aggregate increase includes approximately $40,000 associated with a rate change initiated in August 2005.

- Fees related to credit card operation decreased $187,000 to due to the sale of the Citizens & Northern Bank's credit card operations in December 2005.

- Other operating income increased $94,000, or 27.0%, in 2006 over 2005. Included in this category were increases of $26,000 in ATM debit card fees, and an increase of $82,000 in dividend income on Federal Home Loan Bank of Pittsburgh stock due to a change in the record date for such distributions.

TABLE VI- COMPARISON OF NON-INTEREST EXPENSE

(IN THOUSANDS)	3 MONTHS ENDED MARCH 31, 2006	3 MONTHS ENDED MARCH 31, 2005
Salaries and wages	$3,322	$2,875
Pensions and other employee benefits	1,143	1,032
Occupancy expense, net	546	464
Furniture and equipment expense	650	648
Pennsylvania shares tax	244	215
Other operating expense	1,938	1,894
Total Other Expense	$7,843	$7,128

Salaries and wages increased $447,000, or 15.5%, for 2006 compared to 2005. The increase in salaries expense relates primarily to the increase in the number of full-time equivalent employees, which increased 14.0%, to 365 as of March 31, 2006 from 320 as of March 31, 2005. For 2006, new branch operations at Jersey Shore, Old Lycoming Township and First State Bank added $232,000 to salaries expense.

Pension and other employee benefits associated with the new branch operations added $67,000 in 2006 to this category. Pension plan expense increased 37.3%, or $31,000, in 2006 due to lower investment returns for 2005 than included in the actuarial assumptions, as well as increases in the number of employees and covered compensation, which include employees from First State Bank.

Occupancy Expense increased $82,000, or 17.7%, in 2006 compared to 2005. Total occupancy costs in 2006 include $71,000, or 13.0% of 2006 occupancy costs, for new locations, including First State Bank.

Other Operating Expense increased $44,000 or 2.3% in 2006 compared to 2005. The increase in other expenses is primarily associated with such costs for First State Bank in 2006, which amounted to $207,000, including $62,000 for the amortization of core deposit intangibles. Other expenses include legal and professional fees, as well as expenses associated with maintaining and preparing other real estate (ORE) properties for sale. In 2006, attorney fees related to collection activities on a large commercial credit decreased $66,000, and ORE properties expenses decreased $43,000 in 2006 compared to 2005. In addition, 2005 costs associated with the 2005 NASDAQ Small Cap registration of $34,000 did not recur in 2006; NASDAQ annual fees were at the same level in both years.

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. Also included in the Net Interest Margin section is a discussion of a change in trend regarding short-term and long-term borrowings. The allowance for loan losses and stockholders' equity are discussed in separate sections of Management's Discussion and Analysis.

As discussed in the "Prospects for the Remainder of 2006" section of Management's Discussion and Analysis, the Corporation has completed several planned building construction projects during the quarter which required additional expenditures for completion costs, furnishings and related equipment of approximately $1,600,000. Additional capital expenditures for the remainder of 2006 are expected to be less than $3,000,000 and will relate to normal equipment upgrades and replacements.

PROVISION AND ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses reflects probable losses resulting from the analysis of individual loans and historical loss experience, as modified for identified trends and concerns, for each loan category. The historical loan loss experience element is determined based on the ratio of net charge-offs to average loan balances over a three-year period, for each significant type of loan, modified for qualitative risk adjustment factors identified by management for each type of loan. The charge-off ratio and qualitative factors are then applied to the current outstanding loan balance for each type of loan (net of other loans that are individually evaluated).

The allowance for loan losses was $8,915,000 at March 31, 2006, an increase of $554,000 from the balance at December 31, 2005. Net charge-offs amounted to $46,000 in the first three months of 2006, while the provision for loan losses was $600,000. In the first three months of 2005, net charge-offs totaled $237,000, and the provision was $375,000. The amount of the provision in each period is determined based on the amount required to maintain an appropriate allowance in light of the factors described above. As discussed in more detail below, the higher provision for loan losses in the first quarter 2006 over the same period of 2005 reflected an increase in the unallocated allowance as of March 31, 2006 over December 31, 2005, as well as an increase in the allowance for impaired loans.

In the second quarter 2005, management changed its process for determining and disclosing the components of the allowance for loan losses. A management committee evaluated several qualitative factors, including economic conditions, lending policies, changes in the portfolio, risk profile of the portfolio, competition and regulatory requirements, and other factors. This analysis was performed separately for the following categories of lending activity: commercial, mortgage, consumer and credit card. The management committee has met again quarterly thereafter and updated its analysis (excluding credit card, for which substantially all of the loans were sold in the fourth quarter 2005). Based on the results of these evaluations, allocations were made to the components of the allowance shown in Table VIII. For periods prior to 2005, Table VIII includes the portion of the allowance determined by management's subjective assessment of economic conditions and other factors in the unallocated component of the allowance. Primarily as a result of this change in process, Table VIII shows the amounts allocated to the allowance for commercial, consumer mortgage and consumer

loans at March 31, 2006 and December 31, 2005 have increased in comparison to the corresponding amounts at December 31, 2004 and previous years, while the unallocated portion of the allowance was $382,000 at March 31, 2006 and $0 at December 31, 2005, down from $2,578,000 at December 31, 2004.

As indicated in Table IX, total impaired loans amounted to $8,967,000 at March 31, 2006, as compared to $8,216,000 at December 31, 2005, $8,261,000 at December

31, 2004 and $4,621,000 at December 31, 2003. In total, the valuation allowance related to impaired loans amounted to $2,603,000 at March 31, 2006, up from $2,374,000 at December 31, 2005 and $1,378,000 at December 31, 2004. Table IX also shows that the amount of loans classified as non-accrual amounted to $9,176,000 at March 31, 2006, as compared to $6,365,000 at December 31, 2005, $7,796,000 at December 31, 2004 and $1,145,000 at December 31, 2003. The net growth in impaired and non-accrual loans that has occurred over the course of 2004, 2005 and the first quarter 2006 is mainly attributable to a few large commercial relationships. In the first quarter 2006, a commercial loan with a total balance of $2,025,000 was identified as impaired, and an estimated valuation allowance of $500,000 was established. Also, there are two other large commercial relationships that make up a significant portion of the impaired and non-accrual totals as of March 31, 2006 and December 31, 2005. The total outstanding loan balances from these two relationships was $4,172,000 as of March 31, 2006 and December 31, 2005, and the related valuation allowance totaled $1,124,000 at March 31, 2006 and $1,089,000 at December 31, 2005. Management believes it has been conservative in its decisions concerning identification of impaired loans, estimates of loss and non-accrual status. However, the actual losses realized from these relationships could vary materially from the allowances calculated as of March 31, 2006. Management continues to closely monitor these commercial loan relationships, and will adjust its estimates of loss and decisions concerning non-accrual 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

(IN THOUSANDS)	QUARTER ENDED MARCH 31, 2006	QUARTER ENDED MARCH 31, 2005	YEARS ENDED DECEMBER 31, 2005	2004	2003	2002	
Balance, beginning of year	$8,361	$6,787	$6,787	$6,097	$5,789	$5,265	$
Charge-offs:							
Real estate loans	9	100	264	375	168	123	
Installment loans	73	56	224	217	326	116	
Credit cards and related plans	9	65	198	178	171	190	
Commercial and other loans	8	61	298	16	303	123	
Total charge-offs	99	282	984	786	968	552	
Recoveries:							
Real estate loans	--	12	14	3	75	30	
Installment loans	15	24	61	32	52	30	
Credit cards and related plans	12	4	30	23	17	18	
Commercial and other loans	26	5	50	18	32	58	
Total recoveries	53	45	155	76	176	136	
Net charge-offs	46	237	829	710	792	416	
Allowance for loan losses recorded in acquisition	--	--	377	--	--	--	
Provision for loan losses	600	375	2,026	1,400	1,100	940	
Balance, end of period	$8,915	$6,925	$8,361	$6,787	$6,097	$5,789	$

====== ====== ====== ====== ====== ====== =

CITIZENS & NORTHERN CORPORATION - FORM 10-Q

TABLE VIII - ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES BY TYPE

(IN THOUSANDS)	AS OF MARCH 31, 2006	AS OF DECEMBER 31, 2005	2004	2003	2002	2001
Commercial	$2,357	$2,705	$1,909	$1,578	$1,315	$ 852
Consumer mortgage	2,969	2,806	513	456	460	188
Impaired loans	2,603	2,374	1,378	1,542	1,877	1,736
Consumer	604	476	409	404	378	302
Unallocated	382	--	2,578	2,117	1,759	2,187
Total Allowance	$8,915	$8,361	$6,787	$6,097	$5,789	$5,265

TABLE IX - PAST DUE AND IMPAIRED LOANS

(IN THOUSANDS)	MAR. 31, 2006	DEC. 31, 2005	DEC. 31, 2004	DEC. 3 2003
Impaired loans without a valuation allowance	$ 819	$ 910	$3,552	$ 11
Impaired loans with a valuation allowance	8,148	7,306	4,709	4,50
Total impaired loans	$8,967	$8,216	$8,261	$4,62
Valuation allowance related to impaired loans	$2,603	$2,374	$1,378	$1,54
Total non-accrual loans	$9,176	$6,365	$7,796	$1,14
Total loans past due 90 days or more and still accruing	$1,139	$1,369	$1,307	$2,54

TABLE X - SUMMARY OF LOANS BY TYPE

(IN THOUSANDS)	MARCH 31, 2006	AS OF DECEMBER 31, 2005	2004	2003	2002	20
Real estate - construction	$ 8,545	$ 5,552	$ 4,178	$ 2,856	$ 103	$ 1
Real estate - residential mortgage	366,306	361,857	347,705	330,807	292,136	245
Real estate - commercial mortgage	175,907	153,661	128,073	100,240	78,317	60
Consumer	32,520	31,559	31,702	33,977	31,532	29

Agricultural	2,199	2,340	2,872	2,948	3,024	2
Commercial	38,089	69,396	43,566	34,967	30,874	24
Other	1,844	1,871	1,804	1,183	2,001	1
Political subdivisions	27,576	27,063	19,713	17,854	13,062	13
Lease receivables	--	--	--	65	96	
Total	652,986	653,299	579,613	524,897	451,145	379
Less: allowance for loan losses	(8,915)	(8,361)	(6,787)	(6,097)	(5,789)	(5
Loans, net	$644,071	$644,938	$572,826	$518,800	$445,356	$373

21

CITIZENS & NORTHERN CORPORATION - FORM 10-Q

DERIVATIVE FINANCIAL INSTRUMENTS

The Corporation has utilized derivative financial instruments related to a certificate of deposit product called the "Index Powered Certificate of Deposit" (IPCD). IPCDs have a term of 5 years, with interest paid at maturity based on 90% of the appreciation (as defined) in the S&P 500 index. There is no guaranteed interest payable to a depositor of an IPCD - however, assuming an IPCD is held to maturity, a depositor is guaranteed the return of his or her principal, at a minimum. In 2004, the Corporation stopped originating new IPCDs, but continues to maintain and account for IPCDs and the related derivative contracts entered into between 2001 and 2004.

Statement of Financial Accounting Standards No. 133 requires the Corporation to separate the amount received from each IPCD issued into 2 components: (1) an embedded derivative, and (2) the principal amount of each deposit. Embedded derivatives are derived from the Corporation's obligation to pay each IPCD depositor a return based on appreciation in the S&P 500 index. Embedded derivatives are carried at fair value, and are included in other liabilities in the consolidated balance sheet. Changes in fair value of the embedded derivative are included in other expense in the consolidated income statement. The difference between the contractual amount of each IPCD issued, and the amount of the embedded derivative, is recorded as the initial deposit (included in interest-bearing deposits in the consolidated balance sheet). Interest expense is added to principal ratably over the term of each IPCD at an effective interest rate that will increase the principal balance to equal the contractual IPCD amount at maturity.

In connection with IPCD transactions, the Corporation has entered into Equity Indexed Call Option (Swap) contracts with the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh). Under the terms of the Swap contracts, the Corporation must pay FHLB-Pittsburgh quarterly amounts calculated based on the contractual amount of IPCDs issued times a negotiated rate. In return, FHLB-Pittsburgh is obligated to pay the Corporation, at the time of maturity of the IPCDs, an amount equal to 90% of the appreciation (as defined) in the S&P 500 index. If the S&P 500 index does not appreciate over the term of the related IPCDs, the FHLB-Pittsburgh would make no payment to the Corporation. The effect of the Swap contracts is to limit the Corporation's cost of IPCD funds to the market rate of interest paid to FHLB-Pittsburgh. (In addition, the Corporation paid a fee of 0.75% to a consulting firm at inception of each deposit. These fees are being amortized to interest expense over the term of the IPCDs.) Swap assets or liabilities are carried at fair value, and included in other assets or other liabilities in the consolidated balance sheet. Changes in fair value of swap liabilities are included in other expense in the consolidated income statement.

Amounts recorded as of March 31, 2006 and December 31, 2005, and for the first quarters of 2006 and 2005, related to IPCDs are as follows (in thousands):

	MARCH 31, 2006	DEC. 31, 2005
Contractual amount of IPCDs (equal to notional amount of Swap contracts)	$3,947	$3,952
Carrying value of IPCDs	3,765	3,733
Carrying value of embedded derivative liabilities	558	558
Carrying value of Swap contract (assets) liabilities	(386)	(346)

	3 MONTHS ENDED MARCH 31, 2006	3 MONTHS ENDED MARCH 31, 2005
Interest expense	$39	$40
Other expense	--	--

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 FHLB - Pittsburgh, secured by mortgage loans and various investment securities. At March 31, 2006, the Corporation had unused borrowing availability with correspondent banks and the Federal Home Loan Bank of Pittsburgh totaling approximately $163,127,000. Additionally, the Corporation uses repurchase agreements placed with brokers to borrow funds secured by investment assets, and uses "RepoSweep" arrangements to borrow funds from commercial banking customers on an overnight basis. Further, if required to raise cash in an emergency situation, the Corporation could sell non-pledged investment securities to meet its obligations. At March 31, 2006, the carrying value of non-pledged securities was $182,223,000.

Management believes the combination of its strong capital position (discussed in the next section), ample available borrowing facilities and substantial non-pledged securities portfolio have placed the Corporation in a position of minimal short-term and long-term liquidity risk.

STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY

The Corporation and the subsidiary banks (Citizens & Northern Bank and First

State Bank) are subject to various regulatory capital requirements administered by the federal banking agencies. The Corporation's consolidated capital ratios at March 31, 2006 are as follows:

Total capital to risk-weighted assets	17.83%
Tier 1 capital to risk-weighted assets	16.15%
Tier 1 capital to average total assets	10.79%

Management expects the Corporation and the subsidiary banks to maintain capital levels that exceed the regulatory standards for well-capitalized institutions for the next 12 months and for the foreseeable future. Planned capital expenditures (discussed in the "Financial Position" section of Management's Discussion and Analysis) during the next 12 months, though expected to be substantial, are not expected to have a significantly detrimental effect on capital ratios.

As shown in the consolidated balance sheet, Accumulated Other Comprehensive Income fell to $2,332,000 at March 31, 2006 from $4,698,000 at December 31, 2005. The Accumulated Other Comprehensive Income balance represents unrealized gains and losses on available-for-sale securities, net of deferred income tax. Rising interest rates, which reduce the market prices of debt securities, were a significant factor in the decline in Accumulated Other Comprehensive Income at March 31, 2006 compared to December 31, 2005, as well as the effect of gains realized from the sales of securities during the same period.

INFLATION

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in interest rates. Since mid-2004, the Federal Reserve Board has increased the Fed funds target rate 15 times from 1% to its current level of 4.75%. Further concerns about the possibility of inflation could lead to further increases in the Fed funds target rate, which management believes would be detrimental to the corporation's net interest margin. Although management cannot predict future changes in the rate of inflation, management monitors the impact of economic trends, including any indicators of inflationary pressure, in managing interest rate and other financial risks.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

MARKET RISK

The Corporation's two 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 a significant 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 short-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.

Citizens & Northern Bank uses a simulation model to calculate the potential effects of interest rate fluctuations on net interest income and the market value of portfolio equity. Only assets and liabilities of Citizens & Northern Bank are included in management's monthly simulation model calculations. Since Citizens & Northern Bank makes up more than 90% of the Corporation's total assets and liabilities, and because Citizens & Northern Bank is the source of the most volatile interest rate risk, management does not consider it necessary to run the model for the remaining entities within the consolidated group. 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.

Citizens & Northern Bank'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 Bank's 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 Table XI shows, as of March 31, 2006 and December 31, 2005, the decline in net interest income and market value exceed the policy threshold marks, if interest rates rise immediately by 200 or 300 basis points. The "out of policy" positions are a reflection of the Corporation's liability sensitive position (on average, deposits and borrowings reprice more quickly than loans and debt securities). Management has reviewed these positions with the Board of Directors monthly throughout 2005 and to date in 2006. In addition, management will continue to evaluate whether to make any changes to asset or liability holdings in an effort to reduce exposure to rising interest 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.

TABLE XI - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES

MARCH 31, 2006 DATA
(IN THOUSANDS)

	PERIOD ENDING MARCH 31, 2007				
BASIS POINT CHANGE IN RATES	INTEREST INCOME	INTEREST EXPENSE	NET INTEREST INCOME (NII)	NII % CHANGE	NII RISK LIMIT
+300	$66,498	$45,678	$20,820	-28.3%	20.0%

+200	64,820	41,162	23,658	-18.6%	15.0%
+100	63,061	36,647	26,414	-9.1%	10.0%
0	61,181	32,131	29,050	0.0%	0.0%
-100	58,681	27,646	31,035	6.8%	10.0%
-200	55,715	23,608	32,107	10.5%	15.0%
-300	52,428	20,197	32,231	11.0%	20.0%

MARCH 31, 2006 DATA, CONTINUED
(IN THOUSANDS)

	MARKET VALUE OF PORTFOLIO EQUITY AT MARCH 31, 2006		
BASIS POINT CHANGE IN RATES	PRESENT VALUE EQUITY	PRESENT VALUE % CHANGE	PRESENT VALUE RISK LIMIT
+300	$ 49,920	-59.5%	45.0%
+200	73,963	-40.0%	35.0%
+100	98,947	-19.8%	25.0%
0	123,300	0.0%	0.0%
-100	140,755	14.2%	25.0%
-200	151,127	22.6%	35.0%
-300	159,675	29.5%	45.0%

DECEMBER 31, 2005 DATA
(IN THOUSANDS)

	PERIOD ENDING DECEMBER 31, 2006				
BASIS POINT CHANGE IN RATES	INTEREST INCOME	INTEREST EXPENSE	NET INTEREST INCOME (NII)	NII % CHANGE	NII RISK LIMIT
+300	$66,381	$43,764	$22,617	-24.8%	20.0%
+200	64,649	39,466	25,183	-16.3%	15.0%
+100	62,850	35,168	27,682	-7.9%	10.0%
0	60,942	30,871	30,071	0.0%	0.0%
-100	58,178	26,573	31,605	5.1%	10.0%
-200	55,000	23,098	31,902	6.1%	15.0%
-300	51,805	19,877	31,928	6.2%	20.0%

MARKET VALUE OF PORTFOLIO EQUITY
AT DECEMBER 31, 2005

BASIS POINT CHANGE IN RATES	PRESENT VALUE EQUITY	PRESENT VALUE % CHANGE	PRESENT VALUE RISK LIMIT
+300	$ 54,493	-56.8%	45.0%
+200	77,762	-38.3%	35.0%
+100	102,136	-19.0%	25.0%
0	126,029	0.0%	0.0%
-100	142,377	13.0%	25.0%
-200	151,148	19.9%	35.0%
-300	160,867	27.6%	45.0%

EQUITY SECURITIES RISK

The Corporation's equity securities portfolio consists primarily of investments in stock of banks and bank holding companies located mainly in Pennsylvania. The Corporation also owns some other stocks and mutual funds. Included in "Other Equity Securities" in the table that follows are preferred stocks issued by U.S. Government agencies with a fair value of $2,000,000 at March 31, 2006 and $1,997,000 at December 31, 2005.

Investments in bank stocks are subject to the risk factors that affect the banking industry in general, including competition from non-bank entities, credit risk, 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. Further, because of the concentration of bank and bank holding companies located in Pennsylvania, these investments could decline in market value if there is a downturn in the state's economy.

Equity securities held as of March 31, 2006 and December 31, 2005 are presented in Table XII.

TABLE XII - EQUITY SECURITIES

(IN THOUSANDS)	COST	FAIR VALUE	HYPOTHETICAL 10% DECLINE IN MARKET VALUE	HYPOTHETICAL 20% DECLINE IN MARKET VALUE
AT MARCH 31, 2006				
Banks and bank holding companies	$19,080	$27,564	$(2,756)	$(5,513)
Other equity securities	4,045	4,551	(455)	(910)
Total	$23,125	$32,115	$(3,211)	$(6,423)

	COST	FAIR VALUE	HYPOTHETICAL 10% DECLINE IN MARKET VALUE	HYPOTHETICAL 20% DECLINE IN MARKET VALUE
AT DECEMBER 31, 2005				
Banks and bank holding companies	$20,010	$28,879	$(2,888)	$(5,776)
Other equity securities	4,023	4,387	(439)	(877)
Total	$24,033	$33,266	$(3,327)	$(6,653)

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.

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.

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

There have been no material changes from the risk factors previously disclosed in Item 1A of the Corporation's Form 10-K filed March 3, 2006

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

a. Issuer Sales of Equity Securities

During the quarter ended March 31, 2006, the Corporation issued 1,700 shares of common stock held in treasury upon the exercise of stock options by employees under the Corporation's equity compensation plans. Exercise price for the stock options was $17.00 per share and resulted in aggregate cash proceeds to the Corporation of $28,900. Treasury shares were issued upon exercise of these options by a small number of employees in reliance upon the private placement exemption from registration under Section 4(2) of the Securities Act of 1933.

c. Issuer Purchases of Equity Securities

On August 19, 2005, the Corporation announced a plan to repurchase shares of its outstanding common stock up to a total of $3 million over the period ending August 31, 2006.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 Company's financial performance. The Corporation announced that it is anticipated such purchases will be made during the remaining period, although no assurance may be given when such purchases will be made or the aggregate number of shares that will be purchased. As of March 31, 2006, the maximum additional value available for purchases under this program is $2,532,000.

The following table sets forth a summary of the purchases by the Corporation, on the open market, of its equity securities for the first quarter of 2006:

PERIOD	TOTAL NUMBER OF SHARES PURCHASED	AVERAGE PRICE PAID PER SHARE	TOTAL DOLLAR VALUE OF SHARES PURCHASED UNDER PROGRAM
January 1-31, 2006	--		
February 1-28, 2006	6,500	$25.75	$167,375
March 1-31, 2006	9,500	25.40	241,300
Quarterly Totals	16,000	$25.54	$408,675

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

3. (i) Articles of Incorporation	Incorporated by reference to the exhibits filed with the Corporation's registration statement on Form S-4 on March 27, 1987.
3. (ii) By-laws	Incorporated by reference to Exhibit 3.1 of the Corporation's Form 8-K filed August 25, 2004
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
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

SIGNATURE PAGE

SIGNATURES

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

CITIZENS & NORTHERN CORPORATION

May 5, 2006
Date

By: Craig G. Litchfield /s/

Chairman, President and Chief
Executive Officer

May 5, 2006
Date

By: Mark A. Hughes /s/

Treasurer and Chief Financial
Officer