

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
November 09, 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 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 000-13222**

**CITIZENS FINANCIAL SERVICES, INC.  
(Exact name of registrant as specified in its charter)**

**PENNSYLVANIA 23-2265045  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer**

**Identification No.)**

**First Citizens National Bank  
15 South Main Street  
Mansfield, Pennsylvania 16933  
(Address of principal executive offices)(Zip Code)**

**Registrant's telephone number, including area code: (570) 662-2121**

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

The number of shares outstanding of the Registrant's Common Stock, as of November 6, 2006; 2,826,970 shares of  
Common Stock, par value \$1.00.

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Citizens Financial Services, Inc.  
Form 10-Q

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**CITIZENS FINANCIAL SERVICES, INC.**  
**CONSOLIDATED BALANCE SHEET**  
**(UNAUDITED)**

<i>(in thousands except share data)</i>	<b>September 30 2006</b>	<b>December 31 2005</b>
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$ 9,616	\$ 8,498
Interest-bearing	26	111
Total cash and cash equivalents	9,642	8,609
Available-for-sale securities	103,301	102,602
Loans (net of allowance for loan losses: 2006, \$3,841; 2005, \$3,664)	407,769	379,139
Premises and equipment	12,574	12,305
Accrued interest receivable	2,407	2,164
Goodwill	8,605	8,605
Bank owned life insurance	7,967	7,743
Other assets	8,389	8,074
<b>TOTAL ASSETS</b>	<b>\$ 560,654</b>	<b>\$ 529,241</b>
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$ 49,741	\$ 50,600
Interest-bearing	398,418	379,199
Total deposits	448,159	429,799
Borrowed funds	64,295	52,674
Accrued interest payable	1,994	1,862
Commitment to purchase investments	-	752
Other liabilities	2,628	2,593
<b>TOTAL LIABILITIES</b>	<b>517,076</b>	<b>487,680</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Common Stock		
\$1.00 par value; authorized 10,000,000 shares; issued		
2,992,896 shares in 2006 and 2,965,257 in 2005, respectively	2,993	2,965
Additional paid-in capital	11,933	11,359
Retained earnings	33,140	31,251
<b>TOTAL</b>	<b>48,066</b>	<b>45,575</b>
Accumulated other comprehensive loss	(1,018)	(1,540)
Less: Treasury Stock, at cost 162,674 shares for 2006 and 118,715 for 2005, respectively	(3,470)	(2,474)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>43,578</b>	<b>41,561</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 560,654</b>	<b>\$ 529,241</b>

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

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**CITIZENS FINANCIAL  
SERVICES, INC.  
CONSOLIDATED  
STATEMENT OF INCOME  
(UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
<i>(in thousands, except per share data)</i>	2006	2005	2006	2005
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 7,226	\$ 6,362	\$ 20,639	\$ 18,386
Interest-bearing deposits with banks	-	3	-	2
Investment securities:				
Taxable	851	698	2,549	2,240
Nontaxable	232	153	679	394
Dividends	74	50	223	156
<b>TOTAL INTEREST INCOME</b>	<b>8,383</b>	<b>7,266</b>	<b>24,090</b>	<b>21,178</b>
<b>INTEREST EXPENSE:</b>				
Deposits	3,067	2,416	8,390	6,840
Borrowed funds	849	383	2,388	1,140
<b>TOTAL INTEREST EXPENSE</b>	<b>3,916</b>	<b>2,799</b>	<b>10,778</b>	<b>7,980</b>
<b>NET INTEREST INCOME</b>	<b>4,467</b>	<b>4,467</b>	<b>13,312</b>	<b>13,198</b>
Provision for loan losses	105	30	225	30
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>4,362</b>	<b>4,437</b>	<b>13,087</b>	<b>13,168</b>
<b>NON-INTEREST INCOME:</b>				
Service charges	827	784	2,342	2,203
Trust	135	161	372	368
Brokerage	45	45	142	138
Insurance	32	61	88	205
Investment securities gains, net	5	-	4	-
Earnings on bank owned life insurance	78	71	224	220
Other	91	109	364	334
<b>TOTAL NON-INTEREST INCOME</b>	<b>1,213</b>	<b>1,231</b>	<b>3,536</b>	<b>3,468</b>
<b>NON-INTEREST EXPENSES:</b>				
Salaries and employee benefits	2,055	1,993	6,078	5,888
Occupancy	261	262	845	846
Furniture and equipment	146	156	442	491
Professional fees	125	132	371	408
Amortization	36	145	216	434
Other	1,075	1,133	3,374	3,439
	<b>3,698</b>	<b>3,821</b>	<b>11,326</b>	<b>11,506</b>

**TOTAL NON-INTEREST  
EXPENSES**

Income before provision for income taxes		<b>1,877</b>		1,847		<b>5,297</b>		5,130
Provision for income taxes		<b>329</b>		529		<b>987</b>		1,232
<b>NET INCOME</b>	<b>\$</b>	<b>1,548</b>	<b>\$</b>	1,318	<b>\$</b>	<b>4,310</b>	<b>\$</b>	3,898
<b>Earnings Per Share</b>	<b>\$</b>	<b>0.55</b>	<b>\$</b>	0.46	<b>\$</b>	<b>1.51</b>	<b>\$</b>	1.35
<b>Cash Dividends Paid Per Share</b>	<b>\$</b>	<b>0.215</b>	<b>\$</b>	0.205	<b>\$</b>	<b>0.640</b>	<b>\$</b>	0.610
Weighted average number of shares outstanding		<b>2,835,763</b>		2,874,181		<b>2,850,211</b>		2,887,619

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

**CITIZENS FINANCIAL  
SERVICES, INC.  
CONSOLIDATED  
STATEMENT OF  
COMPREHENSIVE  
INCOME  
(UNAUDITED)**

<i>(in thousands)</i>	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Net income	\$ 1,548	\$ 1,318	\$ 4,310	\$ 3,898
Other comprehensive income:				
Unrealized gains (losses) on available for sale securities	2,035	(739)	796	(1,580)
Less: Reclassification adjustment for gains included in net income	(5)	-	(4)	-
Other comprehensive income (loss) before tax	2,030	(739)	792	(1,580)
Income tax expense (benefit) related to other comprehensive income	690	(251)	269	(537)
Other comprehensive income (loss), net of tax	1,340	(488)	523	(1,043)
Comprehensive income	\$ 2,888	\$ 830	\$ 4,833	\$ 2,855

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



**CITIZENS FINANCIAL SERVICES, INC.**  
**CONSOLIDATED STATEMENT OF CASH**  
**FLOWS**  
**(UNAUDITED)**

<i>(in thousands)</i>	Nine Months Ended September 30,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 4,310	\$ 3,898
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	225	30
Depreciation and amortization	902	1,091
Amortization and accretion of investment securities	312	552
Deferred income taxes	(73)	224
Investment securities gains, net	(4)	-
Earnings on bank owned life insurance	(224)	(220)
Originations of loans held for sale	(1,847)	(3,566)
Proceeds from sales of loans held for sale	1,871	3,611
Increase in accrued interest receivable	(243)	(301)
Increase (decrease) in accrued interest payable	132	(243)
Other, net	(129)	81
Net cash provided by operating activities	5,232	5,157
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Available-for-sale securities:		
Proceeds from sales of available-for-sale securities	10,402	-
Proceeds from maturity and principal repayments of securities	13,952	13,149
Purchase of securities	(25,322)	(10,046)
Proceeds from redemption of Regulatory Stock	2,204	1,888
Purchase of Regulatory Stock	(2,679)	(1,347)
Net increase in loans	(29,414)	(16,454)
Purchase of premises and equipment	(828)	(169)
Proceeds from sale of premises and equipment	-	200
Proceeds from sale of foreclosed assets held for sale	321	372
Property purchased for future expansion	-	(927)
Net cash used in investing activities	(31,364)	(13,334)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net decrease in deposits	18,360	11,608
Proceeds from long-term borrowings	8,458	8,063
Repayments of long-term borrowings	(4,719)	(3,208)
	7,882	(7,016)

Net increase (decrease) in short-term borrowed funds				
Purchase of Treasury Stock		(996)		(463)
Dividends paid		(1,820)		(1,738)
Net cash provided by financing activities		27,165		7,246
Net increase (decrease) in cash and cash equivalents		1,033		(931)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		8,609		9,339
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$	9,642	\$	8,408
<b>Supplemental Disclosures of Cash Flow Information:</b>				
Interest paid	\$	10,613	\$	8,198
Income taxes paid	\$	1,170	\$	860
Loans transferred to foreclosed property	\$	463	\$	369

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

**CITIZENS FINANCIAL SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 1 - Basis of Presentation**

Citizens Financial Service, Inc., (the “Company”) is a Pennsylvania corporation organized as the holding company of its wholly owned subsidiary, First Citizens National Bank (the “Bank”), and its subsidiary, First Citizens Insurance Agency, Inc. (sometimes collectively referred to herein as the “Company”). All material inter-company balances and transactions have been eliminated in consolidation.

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) and in conformity with U.S. generally accepted accounting principles. Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted.

In the opinion of Management of the registrant, the accompanying interim financial statements for the quarters ended September 30, 2006 and 2005 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the period. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. The financial performance reported for the Company for the nine-month period ended September 30, 2006 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Company’s Annual Report to Shareholders and Form 10-K for the period ended December 31, 2005.

**Note 2 - Earnings per Share**

The following table sets forth the computation of earnings per share. Earnings per share calculations give retroactive effect to stock dividends declared by the Company. The Company has no dilutive securities.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income applicable to common stock	\$ 1,548,000	\$ 1,318,000	\$ 4,310,000	\$ 3,898,000
Weighted average common shares outstanding	2,835,763	2,874,181	2,850,211	2,887,619
Earnings per share	\$ 0.55	\$ 0.46	\$ 1.51	\$ 1.35

**Note 3 - Income Tax Expense**

Income tax expense is less than the amount calculated using the statutory tax rate, primarily the result of tax-exempt income earned from state and municipal securities and loans, and investments in tax credits.

**Note 4 - Employee Benefit Plans**

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 10 of the Company's Consolidated Financial Statements included in the 2005 Annual Report on Form 10-K.

**Defined Benefit Plan**

The following sets forth the components of net periodic benefit costs of the noncontributory defined benefit plan for the nine months ended September 30, 2006 and 2005, respectively (dollars presented in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Service cost	\$ 105	\$ 101	\$ 283	\$ 260
Interest cost	98	91	264	235
Expected return on plan assets	(107)	(105)	(288)	(271)
Net amortization and deferral	23	16	63	42
Net periodic benefit cost	\$ 119	\$ 103	\$ 322	\$ 266

The Company expects to contribute \$442,000 to its defined benefit pension plan in 2006. As of September 30, 2006, no contributions have been made.

**Defined Contribution Plan**

The Company also sponsors a defined contribution, 401(k) plan covering substantially all of its employees. The Company contributes three percent of applicable salaries into the plan. Contributions totaled \$141,000 and \$145,000 for the nine months ended September 30, 2006 and 2005, respectively.

**Note 5 - Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 155, Accounting for Certain Hybrid Instruments, as an amendment of FASB Statements No. 133 and 140. FAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In March 2006, the FASB issued FAS No. 156, Accounting for Servicing of Financial Assets. This Statement, which is an amendment to FAS No. 140, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FAS No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. FAS No. 156 also clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability, requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable, and permits an entity with a separately recognized servicing asset or servicing liability to choose either of the amortization or fair value methods for subsequent measurement. The provisions of FAS No. 156 are effective as of the beginning of the first fiscal year that begins after September 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements, which provides enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The Standard does not expand the use of fair value in any new circumstances. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Early adoption is permitted. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In September 2006, the FASB issued FAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R). FAS No. 158 requires that a company recognize the overfunded or underfunded status of its defined benefit post retirement plans (other than multiemployer plans) as an asset or liability in its statement of financial position and that it recognize changes in the funded status in the year in which the changes occur through other comprehensive income. FAS No. 158 also requires the measurement of defined benefit plan assets and obligations as of the fiscal year end, in addition to footnote disclosures. FAS No. 158 is effective for fiscal years ending after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes. FIN 48 is an interpretation of FAS No. 109, Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN No. 48 requires expanded disclosure with respect to the uncertainty in income taxes and is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"), Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements, providing guidance on quantifying financial statement misstatement and implementation when first applying this guidance. Under SAB No. 108, companies should evaluate a misstatement based on its impact on the current year income statement, as well as the cumulative effect of correcting such misstatements that existed in prior years existing in the current year's ending balance sheet. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-4 ("EITF 06-4"), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. The guidance is applicable to endorsement split-dollar life insurance arrangements, whereby the employer owns and controls the insurance policy, that are associated with a postretirement benefit. EITF 06-4 requires that for a split-dollar life insurance arrangement within the scope of the Issue, an employer should recognize a liability for future benefits in accordance with FAS No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-5 ("EITF 06-5"), Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance. EITF 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition.

## **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Cautionary Statement**

Forward-looking statements may prove inaccurate. We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of Citizens Financial Services, Inc., First Citizens National Bank, First Citizens Insurance Agency, Inc. or the combined company. When we use such words as "believes," "expects," "anticipates," or similar expressions, we are making forward-looking statements. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements. The Company would like to caution readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward looking statement:

- Interest rates could change more rapidly or more significantly than we expect. Additionally, the relative changes in the direction and frequency between short-term versus long-term interest rates, i.e., the yield curve, could move in ways unexpected by management.
- The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
- The stock and bond markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.
- It could take us longer than we anticipate in implementing strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.
  - Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.
- We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition.
  - We may become subject to new and unanticipated accounting, tax, or regulatory practices, regulations or requirements, including the costs of compliance with such changes.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.

### **Introduction**

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for Citizens Financial Service, Inc., a bank holding company and its subsidiary (the Company). Our Company's consolidated financial condition and results of operations consist almost entirely of our wholly owned subsidiary's (First Citizens National Bank) financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding September 30, 2006 financial information. The results of operations for the nine months ended September 30, 2006 are not necessarily indicative of the results you may expect for the full year.

Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 16 banking facilities. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton,



Gillett, Millerton, LeRaysville, Towanda, the Wellsboro Weis Market store and the Mansfield Wal-Mart Super Center. In New York, we have completed construction of our first de novo branch office in the town of Wellsville. We began doing business in the new facility on October 30, 2006. This marks the Company's first office location in New York.

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Risk identification and management are essential elements for the successful management of the Company. In the normal course of business, the Company is subject to various types of risk including interest rate, credit, liquidity and regulatory risk.

Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the direction and frequency of changes in interest rates. Interest rate risk results from various re-pricing frequencies and the maturity structure of the financial instruments owned by the Company. The Company uses its asset/liability and funds management policy to control and manage interest rate risk.

Credit risk represents the possibility that a customer may not perform in accordance with contractual terms. Credit risk results from loans with customers and the purchasing of securities. The Company's primary credit risk is in the loan portfolio. The Company manages credit risk by adhering to an established credit policy and through a disciplined evaluation of the adequacy of the allowance for loan losses. Also, the investment policy limits the amount of credit risk that may be taken in the investment portfolio.

Liquidity risk represents the inability to generate or otherwise obtain funds at reasonable rates to satisfy commitments to borrowers and obligations to depositors. The Company has established guidelines within its asset/liability and funds management policy to manage liquidity risk. These guidelines include, among other things, contingent funding alternatives.

Regulatory risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company and its subsidiary. We can not predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.

Readers should carefully review the risk factors described in other documents our Company files from time to time with the Securities and Exchange Commission, including the Annual Report for the year ended December 31, 2005, filed by our Company and any current reports on Form 8-K filed by us.

We face strong competition in the communities that we serve from other commercial banks, savings banks, and savings and loan associations, some of which are substantially larger institutions than our subsidiary. In addition, insurance companies, investment-counseling firms, and other business firms and individuals offer personal and corporate trust services. We also compete with credit unions, issuers of money market funds, securities brokerage firms, consumer finance companies, mortgage brokers and insurance companies. These entities are strong competitors for virtually all types of financial services.

In recent years, the financial services industry has experienced tremendous change to competitive barriers between bank and non-bank institutions. We must compete with traditional financial institutions, other business corporations that have begun to deliver competing financial services, and banking services that are easily accessible through the internet. Competition for banking services is based on price, nature of product, quality of service, and in the case of certain activities, convenience of location.

### **Trust and Investment Services**

Our Investment and Trust Services Department is committed to helping our customers meet their financial goals. The Trust Department offers professional trust administration, investment management services, estate planning and administration, and custody of securities. We also help the members of our communities prepare for retirement by providing retirement plans for local employers and by managing individual IRA accounts. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Company. As of September 30, 2006 and December 31, 2005, the Trust Department had \$78.4 million and \$75.2 million of assets under management, respectively.

Our Investment Representatives offer full service brokerage services throughout the Bank's market area, and appointments can be made at any First Citizens National Bank branch. The Investment Representatives provide financial planning and help our customers achieve their financial goals with their choice of mutual funds, annuities, health and life insurance. These products are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc.

## **Results of Operations**

### **Overview of the Income Statement**

For the three months ended September 30, 2006, The Company earned \$1,548,000 in net income versus \$1,318,000 in 2005, up \$230,000, or 17.5%. Earnings per share for the third quarter was \$0.55 compared to \$0.46 in 2005.

Annualized return on assets and return on equity for the third quarter was 1.12% and 14.03% compared to 1.03% and 12.55% in 2005.

The Company had net income of \$4,310,000 for the first nine months of 2006 compared with earnings of \$3,898,000 for last year's comparable period, an increase of \$412,000, or 10.6%. Earnings per share for the first nine months of 2006 were \$1.51, compared to \$1.35 last year. Annualized return on assets and return on equity for the nine months of 2006 was 1.06% and 13.18%, respectively, compared with 1.03% and 12.53% for last year's comparable period.

Details of the reasons for this change are discussed on the following pages.

### **Net Interest Income**

Net interest income, the most significant component of earnings, is the amount by which interest income generated from interest-earning assets exceeds interest expense on interest-bearing liabilities.

Net interest income, through the third quarter of 2006, after provision for loan losses, was \$13,087,000 a decrease of \$81,000, compared to the same period in 2005. For the first nine months of 2006, the provision for losses totaled \$225,000. For the first nine months of 2005, the provision was \$30,000.

The following table sets forth the average balances of, and the interest earned or incurred on, each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and rate "spread" created:

## Analysis of Average Balances and Interest Rates (1)

	September 30, 2006			September 30, 2005			September 30, 2004		
	Average Balance (1)	Average Interest Rate	Average Rate	Average Balance (1)	Average Interest Rate	Average Rate	Average Balance (1)	Average Interest Rate	Average Rate
(dollars in thousands)	\$	\$	%	\$	\$	%	\$	\$	%
<b>ASSETS</b>									
Short-term investments:									
Interest-bearing deposits at banks	11	-	1.70	133	2	2.01	1,227	9	0.98
Total short-term investments	11	-	1.70	133	2	2.01	1,227	9	0.98
Investment securities:									
Taxable	84,688	2,805	4.42	84,808	2,432	3.82	98,668	2,864	3.87
Tax-exempt (3)	23,065	1,029	5.95	12,795	597	6.22	6,772	338	6.65
Total investment securities	107,753	3,834	4.74	97,603	3,029	4.14	105,440	3,202	4.05
Loans:									
Residential mortgage loans	207,480	10,905	7.03	200,203	10,249	6.84	190,899	9,949	6.97
Commercial & farm loans	132,662	7,566	7.63	117,033	6,148	7.02	93,648	4,767	6.81
Loans to state & political subdivisions	43,400	1,936	5.96	38,730	1,734	5.99	36,092	1,653	6.12
Other loans	12,855	856	8.90	12,507	822	8.79	12,330	827	8.97
Loans, net of discount (2)(3)(4)	396,397	21,263	7.17	368,473	18,953	6.88	332,969	17,196	6.90
<b>Total interest-earning assets</b>	<b>504,161</b>	<b>25,097</b>	<b>6.66</b>	<b>466,209</b>	<b>21,984</b>	<b>6.30</b>	<b>439,636</b>	<b>20,407</b>	<b>6.21</b>
Cash and due from banks	8,993			8,699			8,473		
Bank premises and equipment	12,280			12,085			10,927		
Other assets	18,610			18,693			18,283		
<b>Total non-interest earning assets</b>	<b>39,883</b>			<b>39,477</b>			<b>37,683</b>		
<b>Total assets</b>	<b>544,044</b>			<b>505,686</b>			<b>477,319</b>		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>									
Interest-bearing liabilities:									
NOW accounts	84,514	1,176	1.86	70,416	445	0.84	61,880	174	0.38
Savings accounts	39,526	96	0.32	40,279	85	0.28	39,323	83	0.28
Money market accounts	45,056	1,036	3.07	47,745	649	1.82	44,322	335	1.01
Certificates of deposit	214,381	6,082	3.79	213,469	5,661	3.55	208,811	5,489	3.51
Total interest-bearing deposits	383,477	8,390	2.93	371,909	6,840	2.46	354,336	6,081	2.29
Other borrowed funds	63,935	2,388	4.99	41,192	1,140	3.70	34,966	684	2.62

<b>Total interest-bearing liabilities</b>	<b>447,412</b>	<b>10,778</b>	<b>3.22</b>	413,101	7,980	2.58	389,302	6,765	2.32
Demand deposits	<b>48,592</b>			46,551			44,553		
Other liabilities	<b>4,665</b>			4,551			4,591		
<b>Total non-interest-bearing liabilities</b>	<b>53,257</b>			51,102			49,144		
<b>Stockholders' equity</b>	<b>43,375</b>			41,061			38,873		
<b>Total liabilities &amp; stockholders' equity</b>	<b>544,044</b>			505,264			477,319		
<b>Net interest income</b>		<b>14,319</b>			14,004			13,642	
Net interest spread (5)			<b>3.44%</b>			3.72%			3.89%
Net interest income as a percentage of average interest-earning assets			<b>3.80%</b>			4.02%			4.15%
Ratio of interest-earning assets to interest-bearing liabilities			<b>1.13</b>			1.13			1.13

(1) Averages are based on daily averages.

(2) Includes loan origination and commitment fees.

(3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%.

(4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.

(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Tax exempt revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Company's 34% Federal statutory rate. The following table represents the adjustment to convert net interest income to net interest on a fully tax equivalent basis for the periods ending September 30, 2006, 2005 and 2004:

	For the nine months ended September 30,		
	2006	2005	2004
Total interest income	\$ 24,090	\$ 21,178	\$ 19,679
Total interest expense	10,778	7,980	6,765
Net interest income	13,312	13,198	12,914
Tax equivalent adjustment	1,007	806	728
Net interest income (fully taxable equivalent)	\$ 14,319	\$ 14,004	\$ 13,642

The following table shows the tax-equivalent effect of changes in volume and rate on interest income and expense.

	2006 vs. 2005 (1)			2005 vs. 2004 (1)		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
<b>Interest Income:</b>						
Short-term investments:						
Interest-bearing deposits at banks	\$ (2)	\$ -	\$ (2)	\$ (12)	\$ 5	\$ (7)
Investment securities:						
Taxable	(3)	376	373	(397)	(35)	(432)
Tax-exempt	459	(27)	432	282	(23)	259
Total investments	456	349	805	(115)	(58)	(173)
Loans:						
Residential mortgage loans	409	247	656	479	(179)	300
Commercial & farm loans	1,017	401	1,418	1,234	147	1,381
Loans to state & political subdivisions	208	(6)	202	119	(38)	81
Other loans	24	10	34	11	(16)	(5)
Total loans, net of discount	1,658	652	2,310	1,843	(86)	1,757
<b>Total Interest Income</b>	<b>2,112</b>	<b>1,001</b>	<b>3,113</b>	<b>1,716</b>	<b>(139)</b>	<b>1,577</b>
<b>Interest Expense:</b>						
Interest-bearing deposits:						
NOW accounts	68	663	731	20	251	271
Savings accounts	(2)	13	11	2	-	2
Money Market accounts	(38)	425	387	23	291	314

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Certificates of deposit	24	397	421	124	48	172
Total interest-bearing deposits	52	1,498	1,550	169	590	759
Other borrowed funds	1,229	19	1,248	83	373	456
<b>Total interest expense</b>	<b>1,281</b>	<b>1,517</b>	<b>2,798</b>	252	963	1,215
<b>Net interest income</b>	\$ 831	\$ (516)	\$ 315	\$ 1,464	\$ (1,102)	\$ 362

(1) The portion of the total change attributable to both volume and rate changes during the year has been allocated to volume and rate components based upon the absolute dollar amount of the change in each component prior to allocation.



As can be seen from the preceding tables, we continue to experience a compression of our net interest margin. During 2006, the Federal Reserve has continued its policy of monetary tightening by raising short-term interest rates. Although the Federal Reserve has not increased rates in the third quarter, they have increased short-term interest rates 425 basis points since June of 2004. Accordingly, our cost of funds (interest paid on deposits and borrowings) has increased significantly. During this same period, long-term rates have remained relatively stable, resulting in a flattening of the yield curve. The rates earned on interest bearing assets have also increased during this period, but have not increased by the same magnitude. As such, our net interest spread has decreased from 3.72% for the first nine months of 2005 to 3.44% for the first nine months of 2006. We would anticipate our interest margin improving as the yield curve returns to a more normal slope. We continue to review various pricing and investment strategies to enhance our current deposit growth while maintaining or improving the current interest margin.

Tax equivalent net interest income rose from \$13,642,000 in 2004 to \$14,004,000 in 2005, and increased to \$14,319,000 in 2006. In the period ending September 30, 2006, net interest income increased \$315,000 on a tax equivalent basis over the same period in 2005. The increased volume of interest-earning assets of \$38.0 million generated an increase in interest income of \$2,112,000 while the increased volume of interest-bearing liabilities of \$34.3 million produced an additional \$1,281,000 of interest expense. Combined, this resulted in an increase due to volume of \$831,000 in net interest income.

Comparing the first nine months of 2006 with 2005, the yield on interest-earning assets increased 36 basis points from 6.30% to 6.66% and the average interest rate on interest-bearing liabilities increased 64 basis points, from 2.58% to 3.22%. As such, the net change in rate resulted in a negative \$516,000 of net interest income primarily due to the flattened yield curve referred to above.

### Provision For Loan Losses

For the nine-month period ending September 30, 2006, we charged \$225,000 to the provision as a result of our quarterly review of the allowance for loan losses, which compares to \$30,000 for the same period last year. The increase is primarily attributable to continued loan growth. Management's quarterly review of the allowance for loan losses is based on the following information: migration analysis of delinquent and non-accrual loans, estimated future losses on loans, recent review of large problem credits, local and national economic conditions, historical loss experience, OCC qualitative factors and peer comparisons.

### Non-interest Income

As detailed below, non-interest income for the three months ended September 30, 2006 totaled \$1,213,000 compared with \$1,231,000 for the same period last year. This represents a decrease of \$18,000, or 1.5%. For the first nine months of 2006, non-interest income increased \$68,000 or 2.0% when compared to 2005. For the year, service charge income increased by \$139,000 as it continues to be the primary source of non-interest income. For the first nine months, account service charges totaled \$2,342,000 compared to \$2,203,000 last year. Most of the increase is attributable to the increase in NSF fees of \$109,000 and an increase of \$50,000 of fee income derived from customers' usage of their debit cards. Insurance revenue is down due to a couple of large annuity sales recognized in 2005 and also an overall decrease in annuity transactions. Other income is up \$51,000 over last year due predominantly to gains recognized from the sale of three foreclosed properties. The following tables show the breakdown of non-interest income for the three months and nine months ended September 30, 2006 and 2005 (dollars in thousands):

	Three months ended September 30,		Change		
	2006	2005	Amount	%	
Service charges	\$ 827	\$ 784	\$ 43	5.5	

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Trust	<b>135</b>	161	(26)	(16.1)
Brokerage	<b>45</b>	45	-	-
Insurance	<b>32</b>	61	(29)	(47.5)
Gains on loans sold	<b>11</b>	24	(13)	(54.2)
Investment securities gains, net	<b>5</b>	-	5	N/A
Earnings on bank owned life insurance	<b>78</b>	71	7	9.9
Other	<b>80</b>	85	(5)	(5.9)
Total	<b>\$ 1,213</b>	\$ 1,231	\$ (18)	(1.5)

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	Nine months ended September 30,			Change	
	2006	2005	Amount	%	
Service charges	\$ 2,342	\$ 2,203	\$ 139	6.3	
Trust	372	368	4	1.1	
Brokerage	142	138	4	2.9	
Insurance	88	205	(117)	(57.1)	
Gains on loans sold	24	45	(21)	(46.7)	
Investment securities gains, net	4	-	4	N/A	
Earnings on bank owned life insurance	224	220	4	1.8	
Other	340	289	51	17.6	
Total	\$ 3,536	\$ 3,468	\$ 68	2.0	

We continue to evaluate means of increasing non-interest income. Recently, management has implemented a debt cancellation program that should help us earn more income than the credit insurance program that it's replacing. Debt cancellation is an agreement with the Bank and a customer that if a covered event takes place, the bank will cancel or suspend the debt owed by the customer. In addition, we are focused on the continued growth of our Trust and brokerage areas as a means to service all of our customers' financial needs and increase non-interest income.

### Non-interest Expense

The tables below reflect the breakdown of non-interest expense and professional fees for the three months ended and the nine months ended September 30, 2006 (dollars in thousands). For the three months ended September 30, 2006 compared to last year, expenses decreased \$123,000. Most of this decrease is attributable to a decrease in the amortization of intangibles, as the core deposit intangible related to the Sovereign acquisition in 2000 was fully amortized as of the end of March, 2006. Salaries and benefits increased by \$62,000 for the three months ended September 30, 2006 compared to 2005 mainly due to increases in insurance, pension expense, and merit increases. Professional fees modestly decreased by \$7,000 compared to 2005.

For the first nine months of 2006, expenses decreased \$180,000 or 1.6% compared to the same period in 2005. The increase in salaries and employee benefits of \$190,000 is due mainly to merit increases and higher costs for health insurance and pension expense. Furniture and equipment costs are down \$49,000 due to decreased depreciation expense from assets becoming fully depreciated. Professional fees are down mainly due to a decrease of legal fees. The amortization of intangibles has decreased \$218,000 through the first nine months of 2006, as discussed above.

	Three months ended September 30,			Change	
	2006	2005	Amount	%	
Salaries and employee benefits	\$ 2,055	\$ 1,993	\$ 62	3.1	
Occupancy	261	262	(1)	(0.4)	
Furniture and equipment	146	156	(10)	(6.4)	
Professional fees	125	132	(7)	(5.3)	
Amortization of intangibles	36	145	(109)	(75.2)	
Other	1,075	1,133	(58)	(5.1)	
Total	\$ 3,698	\$ 3,821	\$ (123)	(3.2)	

	Three months ended September 30,			Change	
	2006	2005	Amount	%	
Other professional fees	\$ 68	\$ 73	\$ (5)	(6.8)	
Legal fees	21	23	(2)	(8.7)	
Examinations and audits	36	36	-	-	

Total	\$	<b>125</b>	\$	132	\$	(7)	(5.3)
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	Nine months ended September 30,		Change	
	2006	2005	Amount	%
Salaries and employee benefits	\$ 6,078	\$ 5,888	\$ 190	3.2
Occupancy	845	846	(1)	(0.1)
Furniture and equipment	442	491	(49)	(10.0)
Professional fees	371	408	(37)	(9.1)
Amortization of intangibles	216	434	(218)	(50.2)
Other	3,374	3,439	(65)	(1.9)
Total	\$ 11,326	\$ 11,506	\$ (180)	(1.6)

	Nine months ended September 30,		Change	
	2006	2005	Amount	%
Other professional fees	\$ 215	\$ 223	\$ (8)	(3.6)
Legal fees	50	72	(22)	(30.6)
Examinations and audits	106	113	(7)	(6.2)
Total	\$ 371	\$ 408	\$ (37)	(9.1)

### Provision For Income Taxes

Income before the provision for income taxes has increased \$167,000 in 2006 compared with last year. However, the provision for income taxes has decreased from \$1,232,000 to \$987,000, a reduction of \$245,000. The decrease was primarily a result of our increase in tax-exempt municipal securities and municipal loans. Our current tax-exempt securities and loan portfolio totals approximately \$67.6 million compared with approximately \$55.7 million this time last year.

We are also involved in two limited partnership agreements to establish low-income housing projects in our market area. As a result of these agreements for tax purposes, we have recognized \$547,863 out of a total \$911,000 of tax credits from one project and \$182,856 out of a total \$385,000 on the second project, which was completed in November 2001. A total of approximately \$1,296,000 of tax credits is anticipated over a ten-year period. In 2005, we entered into a third limited liability partnership for a low-income housing project for senior citizens in our Sayre market area. We expect to recognize approximately \$574,000 of tax credits over a ten year period beginning late in 2006.

### Financial Condition

Total assets (as shown in the Consolidated Balance Sheet) of \$560.7 million have increased 5.9% since year-end 2005's balance of \$529.2 million. Net loans increased 7.6% to \$407.8 million while investment securities increased .7% to \$103.3 million. Total deposits have increased \$18.4 million or 4.3% to \$448.2 million since year-end 2005. Borrowed funds have increased \$11.6 million to \$64.3 million compared with \$52.7 million at year-end. Explanations of variances will be described within the following appropriate sections.

### Cash and Cash Equivalents

Cash and cash equivalents totaled \$9,642,000 at September 30, 2006 compared to \$8,609,000 at December 31, 2005. Non-interest bearing cash increased \$1,118,000 since year-end 2005, while interest-bearing cash decreased \$85,000 during that same period. The increase in non-interest bearing cash is primarily attributable to a temporary increase in our balance at the Federal Reserve Bank of Philadelphia. We believe the liquidity needs of the Company, are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, and the

portion of the investment and loan portfolios that mature within one year. These sources of funds will enable the Company to meet cash obligations and off-balance sheet commitments as they come due.

## Investments

As shown in the table below, our investment portfolio increased by \$699,000 or .7% from December 31, 2005 to September 30, 2006. During the first nine months of 2006 we purchased approximately \$7.8 million of U.S. agency bonds, \$9.4 million of mortgage-backed securities, \$3.3 million of tax-exempt municipal securities, and \$3.9 million of corporate bonds. Offsetting this, we continued to receive principal repayments in the amount of \$8.1 million from our mortgaged backed securities portfolio as well as maturities in the amount of \$5.8 million from our corporate and municipal portfolios. We have also sold approximately \$10.4 million of the portfolio in an effort to maximize our total return by reinvesting at higher yields. We sold nearly \$4.0 million of low yielding agencies at losses offset by the sale of a \$2.0 million high yielding corporate. We also sold \$1.9 million of higher yielding mortgage-backed securities and \$1.9 million of Municipal bonds that were pre-refunded and set to be called in the near future. Additionally, we sold 14,900 shares of our Freddie Mac Preferred stock in order to utilize capital gains in prior tax years. The overall market value of our investment portfolio has also decreased approximately \$800,000 due to increases in interest rates which had a direct effect on our investment portfolio. Our investment portfolio is currently yielding 4.75% compared to 4.15% a year ago, on a tax-effected basis.

(dollars in thousands)	September 30, 2006		December 31, 2005	
	Amount	%	Amount	%
Available-for-sale:				
U. S. Agency securities	\$ 16,656	16.1	\$ 12,754	12.5
Obligations of state & political subdivisions	23,762	23.0	22,612	22.0
Corporate obligations	4,915	4.8	8,627	8.4
Mortgage-backed securities	55,323	53.6	55,852	54.4
Other equity securities	2,645	2.5	2,757	2.7
Total	\$ 103,301	100.0	\$ 102,602	100.0

(dollars in thousands)	September 30, 2006/ December 31, 2005	
	Amount	%
Available-for-sale:		
U. S. Agency securities	\$ 3,902	30.6
Obligations of state & political subdivisions	1,150	5.1
Corporate obligations	(3,712)	(43.0)
Mortgage-backed securities	(529)	(0.9)
Other equity securities	(112)	(4.1)
Total	\$ 699	0.7

Management continues to monitor the earnings performance and the effectiveness of the liquidity of the investment portfolio on a regular basis. Through active balance sheet management and analysis of the securities portfolio, the Company maintains sufficient liquidity to satisfy depositor requirements and various credit needs of its customers.

## Loans

The Company's lending is focused in the north central Pennsylvania market and the southern tier of New York. The composition of our loan portfolio consists principally of retail lending, which includes single-family residential mortgages and other consumer lending, and commercial lending primarily to locally-owned small businesses. New

loans are generated primarily from direct loans to our existing customer base, with new customers generated by referrals from real estate brokers, building contractors, attorneys, accountants, business development efforts and existing customers.

As shown in the tables below (dollars in thousands), total loans increased approximately \$28.8 million or 7.5% during the first nine months of 2006. As expected, loan demand picked up in the second and third quarters of 2006. Loans increased \$6.0 in the first quarter, \$12.6 during the second quarter, and \$10.2 for the third quarter. Since the beginning of the year, residential, commercial, and agricultural real estate loans increased \$10.6 million, \$11.5 million and \$2.5 million, respectively. Municipal loans also modestly increased by \$1.3 million.



Residential mortgage lending continues to be a principal business activity and one our Company expects to continue by providing a full complement of competitively priced conforming, nonconforming and home equity mortgages. The Company is continuing its focus on commercial lending as a means to increase loan growth as well as deposits from farmers and small businesses throughout our market area. Lenders have worked diligently on improving organic loan growth while deepening relationships with the goal to better serve customers within our market. We continue to emphasize branch office personnel training and the focus on flexibility and fast “turn around time” that will aid in growing our loan portfolio. Finally, the Company has a strong team of dedicated, experienced professionals that enable us to meet the needs of commercial and agricultural customers within our service area.

(in thousands)	September 30, 2006		December 31, 2005	
	Amount	%	Amount	%
Real estate:				
Residential	\$ 206,193	50.1	\$ 195,628	51.1
Commercial	93,660	22.7	82,128	21.5
Agricultural	15,446	3.8	12,991	3.4
Construction	8,412	2.0	7,245	1.9
Loans to individuals				
for household, family and other purchases	12,754	3.1	13,017	3.4
Commercial and other loans	31,305	7.6	29,260	7.6
State & political subdivision loans	43,840	10.7	42,534	11.1
Total loans	411,610	100.0	382,803	100.0
Less allowance for loan losses	3,841		3,664	
Net loans	\$ 407,769		\$ 379,139	

(in thousands)	September 30, 2006/ December 31, 2005	
	Amount	%
Real estate:		
Residential	\$ 10,565	5.4
Commercial	11,532	14.0
Agricultural	2,455	18.9
Construction	1,167	16.1
Loans to individuals		
for household, family and other purchases	(263)	(2.0)
Commercial and other loans	2,045	7.0
State & political subdivision loans	1,306	3.1
Total loans	\$ 28,807	7.5

### Allowance For Loan Losses

As shown in the table below, the Allowance for Loan Losses as a percentage of loans decreased from .96% at December 31, 2005 to .93% at September 30, 2006. The amount of the allowance increased \$177,000 since year-end 2005. The increase is a result of a \$225,000 provision for the first nine months, less net charge-offs. Gross charge-offs for the first nine months of 2006 were \$203,000, while recoveries were \$155,000.

December 31,

(in thousands)	<b>September 30, 2006</b>	2005	2004	2003	2002
Balance, at beginning of period	\$ 3,664	\$ 3,919	\$ 3,620	\$ 3,621	\$ 3,250
Provision charged to income	225	60	-	435	435
Increase related to acquisition	-	-	290	-	-
Recoveries on loans previously charged against the allowance	155	57	324	116	115
	<b>4,044</b>	4,036	4,234	4,172	3,800
Loans charged against the allowance	<b>(203)</b>	(372)	(315)	(552)	(179)
Balance, at end of year	\$ 3,841	\$ 3,664	\$ 3,919	\$ 3,620	\$ 3,621
Allowance for loan losses as a percent of total loans	<b>0.93%</b>	0.96%	1.09%	1.14%	1.21%
Allowance for loan losses as a percent of non-performing loans	<b>164.71%</b>	163.94%	176.53%	134.62%	119.94%

The adequacy of the allowance for loan losses is subject to a formal analysis by management of the Company. Management deems the allowance to be adequate to absorb inherent losses probable in the portfolio, as of September 30, 2006. The Company has disclosed in its annual report on Form 10-K for the year ended December 31, 2005 the process and methodology supporting the loan loss provision.

## Bank Owned Life Insurance

The Company has elected to purchase bank owned life insurance to offset future employee benefit costs. As of September 30, 2006 the cash surrender value of this life insurance is \$7,967,000, an increase of \$224,000 since year end. The use of life insurance policies provides the bank with an asset that will generate earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits.

## Deposits

Traditional deposits continue to be the most significant source of funds for the Company. As shown in the following tables (dollars in thousands), deposits increased \$18.4 million or 4.3%, since December 31, 2005. As of September 30, 2006, NOW accounts increased by \$11.5 million. Most of the increase in NOW accounts is due to local governmental agencies moving their accounts from money market accounts to NOW accounts during the first nine months of the year. Hence, money market deposit accounts decreased \$4.9 million. Certificates of deposit decreased by \$3.5 million mainly due to the expected redemption of a \$4.2 million deposit from a local school district. In an effort to develop alternative funding sources and to manage our overall cost of funds, we began using brokered deposits in 2006. During the first nine months, we acquired \$15.3 million of brokered deposits with terms ranging from six to eighteen months.

(in thousands)	September 30, 2006		December 31, 2005	
	Amount	%	Amount	%
Non-interest-bearing deposits	\$ 49,741	11.1	\$ 50,600	11.8
NOW accounts	85,097	19.0	73,548	17.1
Savings deposits	39,028	8.7	38,303	8.9
Money market deposit accounts	47,702	10.6	52,632	12.2
Certificates of deposit	210,439	47.0	213,900	49.8
Brokered Deposits	16,152	3.6	816	0.2
Total	\$ 448,159	100.0	\$ 429,799	100.0

(in thousands)	September 30, 2006/ December 31, 2005 Change	
	Amount	%
Non-interest-bearing deposits	\$ (859)	(1.7)
NOW accounts	11,549	15.7
Savings deposits	725	1.9
Money market deposit accounts	(4,930)	(9.4)
Certificates of deposit	(3,461)	(1.6)
Brokered Deposits	15,336	-
Total	\$ 18,360	4.3

## Borrowed Funds

Borrowed funds increased \$11,621,000 during the first nine months of 2006. In an effort to decrease our overall cost of funds, we obtained term funding totaling \$8.0 million through the Federal Home Loan Bank with maturities of two years and under. The funding was needed mainly due to the fact that loans grew at a higher rate than the acquired deposits. The Company's daily cash requirements are met by using the financial instruments available through the Federal Home Loan Bank.

In December 2003, the Company formed a special purpose entity, Citizens Financial Statutory Trust I (“the Entity”), to issue \$7,500,000 of floating rate obligated mandatory redeemable securities as part of a pooled offering. The rate is determined quarterly and floats based on the 3 month LIBOR plus 2.80%. At September 30, 2006, the rate was 8.19%. The Entity may redeem them, in whole or in part, at face value after December 17, 2008. The Company borrowed the proceeds of the issuance from the Entity in December 2003 in the form of a \$7,500,000 note payable, which is included within borrowed funds in the liabilities section of the Company’s balance sheet. Under current accounting rules, the Company’s minority interest in the Entity was recorded at the initial investment amount and is included in the other assets section of the balance sheet. The Entity is not consolidated as part of the Company’s consolidated financial statements.

## Stockholder's Equity

We evaluate stockholders' equity in relation to total assets and the risks associated with those assets. The greater the capital resource, the more likely a corporation is to meet its cash obligations and absorb unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance.

Total Stockholders' Equity was \$43,578,000 at September 30, 2006 compared to \$41,561,000, at December 31, 2005, an increase of \$2,017,000 or 4.9%. Excluding accumulated other comprehensive income, stockholder's equity increased \$1,495,000, or 3.5%. In the first nine months of 2006, the Company had net income of \$4,310,000 and paid dividends of \$1,820,000, representing a dividend payout ratio of 42.2%. The Company also purchased 43,959 shares of treasury stock for \$996,260 at a weighted average cost of \$22.66 per share.

All of the Company's investment securities are classified as available-for-sale making this portion of the Company's balance sheet more sensitive to the changing market value of investments. Accumulated other comprehensive loss increased \$522,000 compared to December 31, 2005 as a result of interest rate movements.

The Company has also complied with standards of being well capitalized mandated by the banking regulators. The Company's primary regulators have established "risk-based" capital requirements designed to measure capital adequacy. Risk-based capital ratios reflect the relative risks associated with various assets entities hold in their portfolios. A weight category of 0% (lowest risk assets), 20%, 50%, or 100% (highest risk assets), is assigned to each asset on the balance sheet. The Company's computed risk-based capital ratios are as follows:

(dollars in thousands)	September 30, 2006		December 31, 2005	
	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)				
Company	\$ 46,871	12.57%	\$ 44,731	12.88%
For capital adequacy purposes	29,829	8.00%	27,793	8.00%
To be well capitalized	37,286	10.00%	34,741	10.00%
Tier I capital (to risk-weighted assets)				
Company	\$ 43,008	11.53%	\$ 41,067	11.82%
For capital adequacy purposes	14,914	4.00%	13,897	4.00%
To be well capitalized	22,372	6.00%	20,845	6.00%
Tier I capital (to average assets)				
Company	\$ 43,008	7.91%	\$ 41,067	8.04%
For capital adequacy purposes	21,741	4.00%	20,440	4.00%
To be well capitalized	27,176	5.00%	25,551	5.00%

The Bank's computed risk-based capital ratios are as follows:

(dollars in thousands)	September 30, 2006		December 31, 2005	
	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)				
Bank	\$ 40,295	10.82%	\$ 37,203	10.72%
For capital adequacy purposes	29,799	8.00%	27,771	8.00%
To be well capitalized	37,248	10.00%	34,714	10.00%
Tier I capital (to risk-weighted assets)				
Bank	\$ 36,434	9.78%	\$ 33,538	9.66%
For capital adequacy purposes	14,899	4.00%	13,886	4.00%
To be well capitalized	22,349	6.00%	20,828	6.00%
Tier I capital (to average assets)				
Bank	\$ 36,434	6.71%	\$ 33,538	6.57%
For capital adequacy purposes	21,729	4.00%	20,430	4.00%
To be well capitalized	27,162	5.00%	25,537	5.00%

On April 4, 2001, our Company filed a Registration Statement on Form S-3 establishing a Dividend Re-Investment Plan (DRIP), which was effective for the second quarter dividend in 2001. As of September 30, 2006 we have 447 shareholders participating representing 350,751 shares and the total number of shares purchased since the inception of the plan is 43,785. On July 19, 2006, the DRIP was amended requiring shareholders of record on or after August 1, 2006 to enroll a minimum of 100 shares to be eligible for participation. Those shareholders participating as of July 31, 2006 who have less than 100 shares may continue participation in the DRIP.

At its Annual Meeting of Shareholders on April 19, 2006, the shareholders approved the 2006 Restricted Stock Plan (2006 Plan). The 2006 Plan will provide stock compensation to selected employees and non-employee directors based upon the Company's performance and other factors. 100,000 shares have been authorized to be awarded through the term of the 2006 Plan, which expires April 18, 2016. Through September 30, 2006, no shares have been awarded.

### Off Balance Sheet Activities

Some financial instruments, such as loan commitments, credit lines, and letters of credit are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at September 30, 2006 (dollars in thousands):

Commitments to extend credit	\$ 60,516
Standby letters of credit	2,193
	\$ 62,709

### Liquidity

Liquidity is a measure of our Company's ability to efficiently meet normal cash flow requirements of both borrowers and depositors. To maintain proper liquidity, we use funds management policies along with our investment policies to assure we can meet our financial obligations to depositors, credit customers and stockholders. Liquidity is needed to meet depositors' withdrawal demands, extend credit to meet borrowers' needs, provide funds for normal operating

expenses and cash dividends, and to fund other capital expenditures.

Our Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows from investing and financing activities.

Cash generated by operating activities, investing activities and financing activities influences liquidity management. The most important source of funds is the deposits that are primarily core deposits (deposits from customers with other relationships). Short-term debt from the Federal Home Loan Bank supplements our Company's availability of funds as well as line of credit arrangements with corresponding banks. Other sources of short-term funds include brokered CD's and the sale of loans and investments, if needed.

Our Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other significant uses of funds include purchasing Regulatory Stock, as well as capital expenditures. Capital expenditures during the first nine months of 2006 were \$828,000, a decrease of \$268,000 from the same period in 2005. \$927,000 was spent in 2005 to purchase property for future expansion.

Our Company achieves additional liquidity primarily from temporary or short-term investments in the Federal Home Loan Bank of Pittsburgh, PA, and investments that mature in less than one year. The Company also has a maximum borrowing capacity at the Federal Home Loan Bank of approximately \$221.7 million as an additional source of liquidity.

Apart from those matters described above, management does not currently believe that there are any current trends, events or uncertainties that would have a material impact on capital.

### **Credit Quality Risk**

The following table identifies amounts of loan losses and non-performing loans. Past due loans are those that were contractually past due 90 days or more as to interest or principal payments (dollars in thousands).

(dollars in thousands)	<b>September 30, 2006</b>	2005	December 31,		2003	2002
			2004			
Non-performing loans:						
Non-accruing loans	\$ 1,049	\$ 867	\$ 722	\$ 578	\$ 1,064	
Impaired loans	842	1,031	1,061	1,926	1,916	
Accrual loans - 90 days or more past due	441	337	437	185	39	
Total non-performing loans	2,332	2,235	2,220	2,689	3,019	
Foreclosed assets held for sale	809	619	712	305	221	
Total non-performing assets	\$ 3,141	\$ 2,854	\$ 2,932	\$ 2,994	\$ 3,240	
Non-performing loans as a percent of loans						
net of unearned income	0.57%	0.58%	0.62%	0.85%	1.01%	
Non-performing assets as a percent of loans						
net of unearned income	0.76%	0.75%	0.82%	0.94%	1.09%	

Interest does not accrue on non-accrual loans. Subsequent cash payments received are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of its ultimate ability to collect principal and interest.

### **Interest Rate and Market Risk Management**

The objective of interest rate sensitivity management is to maintain an appropriate balance between the stable growth of income and the risks associated with maximizing income through interest sensitivity imbalances and the market value risk of assets and liabilities.

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk. Since our Company has no trading portfolio, it is not subject to trading risk.



Currently, our Company has equity securities that represent only 2.7% of our investment portfolio and, therefore, equity risk is not significant.

The primary components of interest-sensitive assets include adjustable-rate loans and investments, loan repayments, investment maturities and money market investments. The primary components of interest-sensitive liabilities include maturing certificates of deposit, IRA certificates of deposit and short-term borrowings. Savings deposits, NOW accounts and money market investor accounts are considered core deposits and are not short-term interest rate sensitive (except for the top-tier money market investor accounts which are paid current market interest rates).

Gap analysis, one of the methods used by us to analyze interest rate risk, does not necessarily show the precise impact of specific interest rate movements on our Company's net interest income because the re-pricing of certain assets and liabilities is discretionary and is subject to competitive and other pressures. In addition, assets and liabilities within the same period may, in fact, be repaid at different times and at different rate levels. We have not experienced the kind of earnings volatility that might be indicated from gap analysis.

Our Company currently uses a computer simulation model to better measure the impact of interest rate changes on net interest income. We use the model as part of our risk management process that will effectively identify, measure, and monitor our Company's risk exposure.

We use numerous interest rate simulations employing a variety of assumptions to evaluate our interest rate risk exposure. A shock analysis during the third quarter of 2006 indicated that a 200 basis point movement in interest rates in either direction would have a minor impact on our Company's anticipated net interest income over the next twenty-four months, well within our ability to manage effectively.

### **General**

The majority of assets and liabilities of a financial institution are monetary in nature and, therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an important impact on the growth of total assets and on non-interest expenses, which tend to rise during periods of general inflation. The ongoing recent action by the Federal Reserve of increasing short-term interest rates should help the level of inflation remain at a relatively low level; however, it has provided significant challenges due to the continued, flattened yield curve.

Various congressional bills have been passed and other proposals have been made for significant changes to the banking system, including changes to deposit insurance reform legislation. This legislation increases coverage for retirement accounts from \$100,000 to \$250,000, merges the existing two deposit insurance funds and indexes the insurance level for inflation

Normal examinations of our Company are performed by the Office of Comptroller of the Currency. The last Community Reinvestment Act performance evaluation by the same agency resulted in a rating of "Outstanding Record of Meeting Community Credit Needs."

Aside from these matters described above and within this Form 10-Q, as well as those discussed in the Company's annual report on Form 10-K for the year ended December 31, 2005, we do not believe that there are any trends, events or uncertainties that would have a material adverse impact on future operating results, liquidity or capital resources. We are not aware of any current recommendations by the regulatory authorities which, if they were to be implemented, would have such an effect, although the general cost of compliance with numerous and multiple federal and state laws and regulations does have, and in the future may have, a negative impact on our Company's results of operations.

### **Item 3-Quantitative and Qualitative Disclosure About Market Risk**

In the normal course of conducting business activities, the Company is exposed to market risk, principally interest rate risk, through the operations of its banking subsidiary. Interest rate risk arises from market driven fluctuations in interest rates that affect cash flows, income, expense and values of financial instruments and was discussed previously in this Form 10-Q. Management and a committee of the board of directors manage interest rate risk.

No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the SEC Form 10-K for the period ended December 31, 2005.

### **Item 4-Control and Procedures**

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, within 90 days prior to the filing date of this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic Securities and Exchange Commission filings. No significant changes were made to our internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation.

**PART II - OTHER INFORMATION****Item 1 - Legal Proceedings**

Management is not aware of any litigation that would have a material adverse effect on the consolidated financial position of the Company. Any pending proceedings are ordinary, routine litigation incidental to the business of the Company and its subsidiary. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Company and its subsidiary by government authorities.

**Item 1A - Risk Factors**

Management is not aware of any material changes in risk factors from those previously disclosed in Part 1, Item 1A of Form 10-K filed for the year ended December 31, 2005.

**Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds****ISSUER PURCHASES OF EQUITY SECURITIES**

<b>Period</b>	<b>Total Number of Shares (or units Purchased)</b>	<b>Average Price Paid per Share (or Unit)</b>	<b>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b>	
7/1/06 to 7/31/06	1,400	\$22.50	1,400	120,638	(1)
8/1/06 to 8/31/06	8,123	\$22.47	8,123	112,515	(1)
9/1/06 to 9/30/06	189	\$22.04	189	112,326	(1)

(1) On January 7, 2006, the Board of Directors authorized the repurchase of 140,000 shares, as filed with the Securities and Exchange Commission on January 20, 2006 on Form 8-K. The repurchase plan does not have an expiration date. As of September 30, 2006, there were 112,326 shares that may yet be repurchased under this plan.

**Item 3 - Defaults Upon Senior Securities**

None

**Item 4 - Submission of Matters to a Vote of Security Holders**

None

**Item 5 - Other Information**

None

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**Item 6 - Exhibits and Reports on Form 8-K.**

3.1	Articles of Incorporation of Citizens Financial Services, Inc., as amended <sup>(1)</sup>
3.2	Bylaws of Citizens Financial Services, Inc. <sup>(2)</sup>
4	Instrument defining the rights of security holders. <sup>(3)</sup>
10.1	Amended and Restated Executive Employment Agreement between Citizens Financial Services, Inc., First Citizens National Bank and Randall E. Black <sup>(4)</sup>
10.2	Consulting and Non-Compete Agreement between Citizens Financial Services, Inc., First Citizens National Bank and Richard E. Wilber <sup>(5)</sup>
10.3	Citizens Financial Services, Inc. Directors' Deferred Compensation Plan <sup>(6)</sup>
10.4	Citizens Financial Services, Inc. Directors' Life Insurance Program <sup>(7)</sup>
11	Statement re computation of per share earnings <sup>(8)</sup>
19	Quarterly Shareholders' Report for the period ended September 30, 2006
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.1	Section 1350 Certification of Chief Executive Officer
32.2	Section 1350 Certification of Chief Financial Officer
99.1	Independent registered public accounting firm's review of financial statements for the period ended September 30, 2006.

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<sup>(1)</sup> Incorporated by reference to Exhibit 3(i) to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, as filed with the Commission on May 11, 2000.

<sup>(2)</sup> Incorporated by reference to Exhibit 3(ii) to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003, as filed with the Commission on April 29, 2004.

<sup>(3)</sup> Incorporated by reference to Exhibit 4 to the Company's quarterly report on Form 10-Q for the quarter ended June 30, 2006, as filed with the Commission on August 10, 2006.

<sup>(4)</sup> Incorporated by reference to Exhibit 99.1 on Form 8-K filed with the Commission on September 19, 2006.

<sup>(5)</sup> Incorporated by Reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003, as filed with the Commission on March 18, 2004.

<sup>(6)</sup> Incorporated by reference to Exhibit 10.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Commission on March 14, 2005.

(7) Incorporated by reference to Exhibit 10.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Commission on March 14, 2005.

(8) The statement regarding computation of per share earnings required by this exhibit is contained in Note 1 to the consolidated financial statements captioned "Earnings Per Share" as part of Item 8 of this report.

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 Financial Services, Inc.  
(Registrant)

Date: November 9, 2006

By: /s/ Randall E. Black

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By: Randall E. Black  
Chief Executive Officer and President  
(Principal Executive Officer)

Date: November 9, 2006

By: /s/ Mickey L. Jones

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By: Mickey L. Jones  
Chief Financial Officer  
(Principal Accounting Officer)



