

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
May 10, 2018

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

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

For the quarterly period ended March 31, 2018  
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 0 13222

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

PENNSYLVANIA  
(State or other jurisdiction of incorporation or  
organization)

23 2265045

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

15 South Main Street  
Mansfield, Pennsylvania 16933  
(Address of principal executive offices)(Zip Code)

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

N/A  
(Former Name, former address and former fiscal year, if changed since last report)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated  
filer  
filer

\_\_\_\_\_

Accelerated

Non-accelerated filer  
reporting company  
(Do not check if a smaller reporting  
company)  
growth company \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Smaller

Emerging



Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 outstanding shares of the Registrant's Common Stock, as of May 2, 2018, was 3,481,687.

---

Citizens Financial Services, Inc.  
Form 10-Q

INDEX

	PAGE
Part I FINANCIAL INFORMATION	
Item 1. Financial Statements (unaudited):	
Consolidated Balance Sheet as of March 31,2018 and December 31, 2017	1
Consolidated Statement of Income for the Three Months Ended March 31, 2018 and 2017	2
Consolidated Statement of Comprehensive Income for the Three Months ended March 31, 2018 and 2017	3
Consolidated Statement of Cash Flows for the Three Months ended March 31, 2018 and 2017	4
Notes to Consolidated Financial Statements	5-31
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	32-51
Item 3. Quantitative and Qualitative Disclosures About Market Risk	51
Item 4. Controls and Procedures	54
Part II OTHER INFORMATION	
Item 1. Legal Proceedings	51
Item 1A. Risk Factors	51
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	52
Item 3. Defaults Upon Senior Securities	52
Item 4. Mine Safety Disclosures	52
Item 5. Other Information	52
Item 6. Exhibits	52-53
Signatures	54

---

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

(in thousands except share data)	March 31, 2018	December 31, 2017
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$10,141	\$16,347
Interest-bearing	2,334	2,170
Total cash and cash equivalents	12,475	18,517
Interest bearing time deposits with other banks	10,532	10,283
Equity securities	188	-
Available-for-sale debt securities	251,340	254,782
Loans held for sale	233	1,439
Loans (net of allowance for loan losses: 2018, \$11,587 and 2017, \$11,190)	1,020,151	989,335
Premises and equipment	16,378	16,523
Accrued interest receivable	4,283	4,196
Goodwill	23,296	23,296
Bank owned life insurance	27,035	26,883
Other intangibles	1,856	1,953
Other assets	14,716	14,679
<b>TOTAL ASSETS</b>	<b>\$1,382,483</b>	<b>\$1,361,886</b>
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$173,124	\$171,840
Interest-bearing	942,029	933,103
Total deposits	1,115,153	1,104,943
Borrowed funds	124,121	114,664
Accrued interest payable	867	897
Other liabilities	12,492	12,371
<b>TOTAL LIABILITIES</b>	<b>1,252,633</b>	<b>1,232,875</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred Stock		
\$1.00 par value; authorized 3,000,000: none issued in 2018 or 2017	-	-
Common stock		
\$1.00 par value; authorized 15,000,000 shares; issued 3,869,939 at March 31, 2018 and December 31, 2017	3,870	3,870
Additional paid-in capital	51,113	51,108
Retained earnings	92,713	89,982
Accumulated other comprehensive income	(4,977 )	(3,398 )
Treasury stock, at cost: 388,177 shares at March 31, 2018 and 383,065 shares at December 31, 2017	(12,869 )	(12,551 )
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>129,850</b>	<b>129,011</b>

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$1,382,483	\$1,361,886
---	-------------	-------------

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

1

---

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

(in thousands, except share and per share data)	Three Months Ended	
	2018	2017
INTEREST INCOME:		
Interest and fees on loans	\$ 11,861	\$ 9,717
Interest-bearing deposits with banks	58	35
Investment securities:		
Taxable	800	804
Nontaxable	527	668
Dividends	137	76
TOTAL INTEREST INCOME	13,383	11,300
INTEREST EXPENSE:		
Deposits	1,316	1,045
Borrowed funds	647	258
TOTAL INTEREST EXPENSE	1,963	1,303
NET INTEREST INCOME	11,420	9,997
Provision for loan losses	500	615
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	10,920	9,382
NON-INTEREST INCOME:		
Service charges	1,104	1,058
Trust	251	221
Brokerage and insurance	181	191
Gains on loans sold	72	101
Equity security gains, net	6	-
Available for sale security gains, net	-	172
Earnings on bank owned life insurance	152	166
Other	140	126
TOTAL NON-INTEREST INCOME	1,906	2,035
NON-INTEREST EXPENSES:		
Salaries and employee benefits	4,835	4,366
Occupancy	592	527
Furniture and equipment	142	139
Professional fees	295	310
FDIC insurance	100	105
Pennsylvania shares tax	300	281
Amortization of intangibles	76	76
ORE expenses	138	90
Other	1,354	1,297
TOTAL NON-INTEREST EXPENSES	7,832	7,191
Income before provision for income taxes	4,994	4,226
Provision for income taxes	747	923
NET INCOME	\$ 4,247	\$ 3,303
PER COMMON SHARE DATA:		
Net Income - Basic	\$ 1.22	\$ 0.94
Net Income - Diluted	\$ 1.22	\$ 0.94

Cash Dividends Paid	\$0.435	\$0.405
Number of shares used in computation - basic	3,478,280	3,479,180
Number of shares used in computation - diluted	3,478,643	3,479,200

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



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

(in thousands)	Three Months Ended	
	March 31,	
	2018	2017
Net income	\$4,247	\$3,303
Other comprehensive loss:		
Change in unrealized gains on available for sale securities	(2,045)	70
Income tax effect	428	(24 )
Change in unrecognized pension cost	46	60
Income tax effect	(9 )	(21 )
Less: Reclassification adjustment for investment security gains included in net income	-	(172)
Income tax effect	-	58
Other comprehensive loss, net of tax	(1,580)	(29 )
Comprehensive income	\$2,667	\$3,274

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

CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)	Three Months Ended March 31,	
(in thousands)	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$4,247	\$3,303
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	500	615
Depreciation and amortization	69	108
Amortization and accretion of investment securities	306	382
Deferred income taxes	(181 )	(174 )
Equity security gains, net	(6 )	-
Available for sale security gains, net	-	(172 )
Earnings on bank owned life insurance	(152 )	(166 )
Originations of loans held for sale	(2,523 )	(4,727 )
Proceeds from sales of loans held for sale	3,772	5,075
Realized gains on loans sold	(72 )	(101 )
(Increase) decrease in accrued interest receivable	(87 )	471
Decrease in accrued interest payable	(30 )	(108 )
Other, net	482	1,801
Net cash provided by operating activities	6,325	6,307
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Available-for-sale securities:		
Proceeds from sales	-	18,766
Proceeds from maturity and principal repayments	22,872	29,858
Purchase of securities	(21,963)	(11,039)
Purchase of interest bearing time deposits with other banks	(249 )	(746 )
Proceeds from redemption of regulatory stock	2,709	2,617
Purchase of regulatory stock	(2,630 )	(1,288 )
Net increase in loans	(31,081)	(45,880)
Purchase of premises and equipment	(41 )	(113 )
Proceeds from sale of interest bearing time deposits with other banks	-	750
Proceeds from sale of foreclosed assets held for sale	195	125
Net cash used in investing activities	(30,188)	(6,950 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	10,210	32,106
Proceeds from long-term borrowings	2	2
Net (decrease) increase in short-term borrowed funds	9,455	(32,828)
Purchase of treasury and restricted stock	(331 )	(396 )
Dividends paid	(1,515 )	(1,198 )
Net cash (used) provided by financing activities	17,821	(2,314 )
Net decrease in cash and cash equivalents	(6,042 )	(2,957 )
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>18,517</b>	<b>17,754</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$12,475</b>	<b>\$14,797</b>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Interest paid	\$1,993	\$1,411

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Income taxes paid	\$-	\$-
Loans transferred to foreclosed property	\$13	\$307
Investments and time deposits sold and not settled	\$-	\$1,297

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 Services, Inc. (individually and collectively with its direct and indirect subsidiaries, the "Company") is a Pennsylvania corporation and the holding company of its wholly owned subsidiary, First Citizens Community Bank (the "Bank"), and of the Bank's wholly owned subsidiary, First Citizens Insurance Agency, Inc. ("First Citizens Insurance").

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. Certain of the prior year amounts have been reclassified to conform with the current year presentation. Such reclassifications had no effect on net income or stockholders' equity. All material inter company balances and transactions have been eliminated in consolidation.

In the opinion of management of the Company, the accompanying interim financial statements at March 31, 2018 and for the periods ended March 31, 2018 and 2017 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 periods. 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 three month period ended March 31, 2018 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 on Form 10-K for the year ended December 31, 2017.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. See Note 2 for additional information related to the adoption of this standard.

In January 2016, the FASB finalized ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This accounting standard (a) requires separate presentation of equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) on the balance sheet and measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in

combination with the entity's other deferred tax assets.

5

---

The adoption resulted in the Company recognizing a one-time cumulative effect adjustment of \$1,000 between accumulated other comprehensive income and retained earnings on the consolidated balance sheet for the fair value of equity securities included in accumulated other comprehensive income as of the beginning of the period. The adjustment had no impact on net income on any prior periods presented.

The Company has adopted this standard during the reporting period. On a prospective basis, the Company implemented changes to the measurement of the fair value of financial instruments using an exit price notion for disclosure purposes included in Note 12 to the financial statements. The March 31, 2018, fair value of each class of financial instruments disclosure did utilize the exit price notion when measuring fair value and, therefore, may not be comparable to the December 31, 2017 disclosure.

In March 2017, the FASB issued ASU 2017-07, Compensation-Retirement Benefits (Topic 71S). The amendments in this Update require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component. The Company adopted the standard on January 1, 2018, which resulted in a reclassification of \$(47) from Salaries and employee benefits into Other noninterest expenses on the Consolidated Statement of Income for the period ended March 31, 2017. See note 10 for additional information on the presentation of these pension cost components.

#### Note 2 – Revenue recognition

Effective January 1, 2017, the Company adopted Accounting Standards Update ASU 2014-09 Revenue from Contracts with Customers – Topic 606 and all subsequent ASUs that modified ASC 606. The Company has elected to apply the standard to all prior periods presented utilizing the full retrospective approach. The implementation of the new standard had no material impact to the measurement or recognition of revenue of prior periods. Management determined that the primary sources of revenue emanating from interest and dividend income on loans and investments along with noninterest revenue resulting from investment security gains, loan servicing, gains on loans sold and earnings on bank owned life insurances are not within the scope of ASC 606. As a result, no changes were made during the period related to these sources of revenue, which cumulatively comprise 89.4 percent of the total revenue of the Company. The main types of noninterest income within the scope of the standard are as follows:

Service charges on deposit accounts – The Company has contracts with its deposit customers where fees are charged if certain parameters are not met. These agreements can be cancelled at any time by either the Company or the deposit customer. Revenue from these transactions is recognized on a monthly basis as the Company has an unconditional right to the fee consideration. The Company also has transaction fees related to specific transactions or activities resulting from a customer request or activity that include overdraft fees, online banking fees, interchange fees, ATM fees and other transaction fees. All of these fees are attributable to specific performance obligations of the Company where the revenue is recognized at a defined point in time upon the completion of the requested service/transaction.

Trust fees – Typical contracts for trust services are based on a fixed percentage of the assets earned ratably over a defined period and billed on a monthly basis. Fees charged to customers' accounts are recognized as revenue over the period during which the Company fulfills its performance obligation under the contract (i.e., holding client asset in a managed fiduciary trust account). For these accounts, the performance obligation of the Company is typically satisfied by holding and managing the customer's assets over time. Other fees related to specific customer requests are attributable to specific performance obligations of the Company where the revenue is recognized at a defined point in time, upon completion of the requested service/transaction.

Gains (losses) on sale of other real estate owned – Gains and losses are recognized at the completion of the property sale when the buyer obtains control of the real estate and all of the performance obligations of the Company have

been satisfied. Evidence of the buyer obtaining control of the asset include transfer of the property title, physical possession of the asset, and the buyer obtaining control of the risks and rewards related to the asset. In situations where the Company agrees to provide financing to facilitate the sale, additional analysis is performed to ensure that the contract for sale identifies the buyer and seller, the asset to be transferred, payment terms, and that the contract has a true commercial substance and that collection of amounts due from the buyer are reasonable. In situations where financing terms are not reflective of current market terms, the transaction price is discounted impacting the gain/loss and the carrying value of the asset.

Brokerage and insurance – Fees includes commissions from the sales of investments and insurance products recognized on a trade date basis as the performance obligation is satisfied at the point in time in which the trade is processed. Additional fees are based on a percentage of the market value of customer accounts and billed on a monthly/quarterly basis. The Company's performance obligation under the contracts with certain customers is generally satisfied through the passage of time as the Company monitors and manages the assets in the customer's portfolio and is not dependent on certain return or performance level of the customer's portfolio. Fees for these services are billed monthly and are recorded as revenue at the end of the month for which the wealth management service has been performed. Other performance obligations (such as the delivery of account statements to customers) are generally considered immaterial to the overall transaction price.

The following table depicts the disaggregation of revenue derived from contracts with customers to depict the nature, amount, timing, and uncertainty of revenue and cash flows for the three months ended March 31, 2018. All revenue in the table below relates to goods and services transferred at a point in time.

Revenue stream:

Service charges on deposit accounts	
Overdraft fees	\$367
Statement fees	54
Interchange revenue	531
ATM income	96
Other service charges	56
Total Service Charges	1,104
Trust	251
Brokerage and insurance	181
Other	85
Total	\$1,621

Note 3 - 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.

	Three months ended	
	March 31,	
	2018	2017
Net income applicable to common stock	\$4,247,000	\$3,303,000
Basic earnings per share computation		
Weighted average common shares outstanding	3,478,280	3,479,180
Earnings per share - basic	\$1.22	\$0.94
Diluted earnings per share computation		
Weighted average common shares outstanding for basic earnings per share	3,478,280	3,479,180
Add: Dilutive effects of restricted stock	363	20
Weighted average common shares outstanding for dilutive earnings per share	3,478,643	3,479,200
Earnings per share - diluted	\$1.22	\$0.94



For the three months ended March 31, 2018 and 2017, there were 426 and 2,087 shares, respectively, related to the restricted stock plan that were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had per share prices ranging from \$49.87-\$61.04 for the three month period ended March 31, 2018 and per share prices ranging from \$49.87-\$53.15 for the three month period ended March 31, 2017.

Note 4 - Income Tax Expense

Income tax expense is less than the amount calculated using the statutory tax rate, primarily as a result of tax-exempt income earned from state and municipal securities and loans and the recognition of qualified affordable housing tax credits.

Investments in Qualified Affordable Housing Projects

As of March 31, 2018 and December 31, 2017, the Company was invested in four partnerships that provide affordable housing. The balance of the investments, which is included within other assets in the Consolidated Balance Sheet, was \$514,000 and \$541,000 as of March 31, 2018 and December 31, 2017, respectively. Investments purchased prior to January 1, 2015, are accounted for utilizing the effective yield method. As of March 31, 2018, the Company had \$670,000 of tax credits remaining that will be recognized over 4.75 years. Tax credits of \$35,000 were recognized as a reduction of tax expense during the three months ended March 31, 2018 and 2017, respectively. Amortization of the investment included in other expenses on the Consolidated Statement of Income was \$27,000 and \$40,000 during the three months ended March 31, 2018 and 2017, respectively.

Note 5 – Investments

The amortized cost, gross unrealized gains and losses, and fair value of investment securities at March 31, 2018 and December 31, 2017 were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2018				
Available-for-sale securities:				
U.S. agency securities	\$ 100,256	\$ 3	\$ (1,073 )	\$ 99,186
U.S. treasury securities	33,768	-	(656 )	33,112
Obligations of state and political subdivisions	71,365	580	(413 )	71,532
Corporate obligations	3,000	50	-	3,050
Mortgage-backed securities in government sponsored entities	45,336	3	(879 )	44,460
Total available-for-sale securities	\$ 253,725	\$ 636	\$ (3,021 )	\$ 251,340

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2017				
Available-for-sale securities:				
U.S. agency securities	\$ 99,454	\$ 26	\$ (593 )	\$ 98,887
U.S. treasury securities	28,782	-	(178 )	28,604
Obligations of state and political subdivisions	78,409	820	(139 )	79,090
Corporate obligations	3,000	83	-	3,083
Mortgage-backed securities in				

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

government sponsored entities	45,385	19	(377 )	45,027
Equity securities in financial institutions	92	-	(1 )	91
Total available-for-sale securities	\$255,122	\$ 948	\$ (1,288 )	\$254,782

8

---

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, which individual securities have been in a continuous unrealized loss position, at March 31, 2018 and December 31, 2017 (in thousands). As of March 31, 2018, the Company owned 138 securities whose fair value was less than their cost basis.

March 31, 2018	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. agency securities	\$70,435	\$ (824 )	\$16,851	\$ (249 )	\$87,286	\$ (1,073 )
U.S. treasury securities	33,112	(656 )	-	-	33,112	(656 )
Obligations of state and political subdivisions	27,327	(298 )	4,795	(115 )	32,122	(413 )
Mortgage-backed securities in government sponsored entities	28,993	(479 )	12,817	(400 )	41,810	(879 )
Total securities	\$159,867	\$ (2,257 )	\$34,463	\$ (764 )	\$194,330	\$ (3,021 )
December 31, 2017						
U.S. agency securities	\$74,952	\$ (421 )	\$16,928	\$ (172 )	\$91,880	\$ (593 )
U.S. treasury securities	28,604	(178 )	-	-	28,604	(178 )
Obligations of states and political subdivisions	14,885	(85 )	5,958	(54 )	20,843	(139 )
Mortgage-backed securities in government sponsored entities	27,154	(190 )	13,822	(187 )	40,976	(377 )
Equity securities in financial institutions	91	(1 )	-	-	91	(1 )
Total securities	\$145,686	\$ (875 )	\$36,708	\$ (413 )	\$182,394	\$ (1,288 )

As of March 31, 2018 and December 31, 2017, the Company's investment securities portfolio contained unrealized losses on agency securities issued or backed by the full faith and credit of the United States government or are generally viewed as having the implied guarantee of the U.S. government, U.S treasury securities, obligations of states and political subdivisions and mortgage backed securities issued by government sponsored entities. For fixed maturity investments management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not other than temporary and is the result of interest rate changes, sector credit rating changes, or issuer-specific rating changes that are not expected to result in the non-collection of principal and interest during the period.

Proceeds from sales of securities available-for-sale for the three months ended March 31, 2017 were \$18,766,000. There were no sales of available for sale securities during the three months ended March 31, 2018. The gross gains and losses were as follows (in thousands):

	Three Months Ended March 31, 201 <del>8</del> 2017
Gross gains on available for sale securities	- \$172
Gross losses on available for sale securities	- -
Net gains	\$- \$172

9

---

The following table presents the net gains on the Company's equity investments recognized in earnings during the three month period ended March 31, 2018, and the portion of unrealized gains for the period that relates to equity investments held at March 31, 2018.

Net gains recognized in equity securities during the period	\$	6
Less: Net gains realized on the sale of equity securities during the period		-
Net gains	\$	6

Investment securities with an approximate carrying value of \$242.9 million and \$243.4 million at March 31, 2018 and December 31, 2017, respectively, were pledged to secure public funds and certain other deposits.

Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and fair value of debt securities (excludes equity securities) at March 31, 2018, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Fair Value
Available-for-sale debt securities:		
Due in one year or less	\$ 37,488	\$ 37,579
Due after one year through five years	120,367	118,940
Due after five years through ten years	42,684	42,068
Due after ten years	53,186	52,753
Total	\$ 253,725	\$ 251,340

#### Note 6 – Loans

The Company grants loans primarily to customers throughout north central, central and south central Pennsylvania and the southern tier of New York. Although the Company had a diversified loan portfolio at March 31, 2018 and December 31, 2017, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions. The following table summarizes the primary segments of the loan portfolio and how those segments are analyzed within the allowance for loan losses as of March 31, 2018 and December 31, 2017 (in thousands):

	Total Loans	Individually evaluated for impairment	Loans acquired with deteriorated credit quality	Collectively evaluated for impairment
March 31, 2018				
Real estate loans:				
Residential	\$215,349	\$ 1,234	\$ 31	\$214,084
Commercial	320,381	13,949	1,422	305,010
Agricultural	248,710	3,818	689	244,203
Construction	22,239	-	-	22,239
Consumer	9,672	-	-	9,672

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Other commercial loans	74,930	4,139	442	70,349
Other agricultural loans	40,396	1,380	-	39,016
State and political subdivision loans	100,061	-	-	100,061
Total	1,031,738	24,520	2,584	1,004,634
Allowance for loan losses	11,587	408	-	11,179
Net loans	\$1,020,151	\$ 24,112	\$ 2,584	\$993,455

10

---

December 31, 2017	Total Loans	Individually evaluated for impairment	Loans acquired with deteriorated credit quality	Collectively evaluated for impairment
Real estate loans:				
Residential	\$214,479	\$ 1,065	\$ 33	\$ 213,381
Commercial	308,084	13,864	1,460	292,760
Agricultural	239,957	3,901	702	235,354
Construction	13,502	-	-	13,502
Consumer	9,944	8	-	9,936
Other commercial loans	72,013	4,197	443	67,373
Other agricultural loans	37,809	1,363	-	36,446
State and political subdivision loans	104,737	-	-	104,737
Total	1,000,525	24,398	2,638	973,489
Allowance for loan losses	11,190	410	-	10,780
Net loans	\$989,335	\$ 23,988	\$ 2,638	\$ 962,709

Purchased loans acquired in The First National Bank of Fredericksburg (FNB) acquisition and the State College branch acquisition, were recorded at fair value on their purchase date without a carryover of the related allowance for loan losses. Upon acquisition, the Company evaluated whether an acquired loan was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired ("PCI") loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. Based upon management's review, there were no material increases or decreases in the expected cash flows of these loans between the acquisition date and March 31, 2018. The fair value of PCI loans, on the acquisition date, was determined, primarily based on the fair value of the loans' collateral. The carrying value of PCI loans was \$2,584,000 and \$2,638,000 at March 31, 2018 and December 31, 2017, respectively. The carrying value of the PCI loans was determined by projected discounted contractual cash flows.

Changes in the accretable yield for PCI loans were as follows for the three months ended March 31, 2018 and 2017, respectively (in thousands):

	Three months ended March 31,	
	2018	2017
Balance at beginning of period	\$ 106	\$ 389
Accretion	(24)	(114)
Balance at end of period	\$ 82	\$ 275

The following table presents additional information regarding loans acquired with specific evidence of deterioration in credit quality under ASC 310-30 (in thousands):

	March 31, 2018	December 31, 2017
Outstanding balance	\$ 5,284	\$ 5,295

Carrying amount	2,584	2,638
-----------------	-------	-------

The segments of the Company's loan portfolio are disaggregated into classes to a level that allows management to monitor risk and performance. Residential real estate mortgages consist primarily of 15 to 30 year first mortgages on residential real estate, while residential real estate home equity loans are consumer purpose installment loans or lines of credit with terms of 15 years or less secured by a mortgage which is often a second lien on residential real estate. Commercial real estate loans are business purpose loans secured by a mortgage on commercial real estate. Agricultural real estate loans are loans secured by a mortgage on real estate used in agriculture production. Construction real estate loans are loans secured by residential, commercial or agricultural real estate used during the construction phase of residential, commercial or agricultural projects. Consumer loans are typically unsecured or primarily secured by assets other than real estate and overdraft lines of credit are typically secured by customer deposit accounts. Other commercial loans are loans for commercial purposes primarily secured by non-real estate collateral. Other agricultural loans are loans for agricultural purposes primarily secured by non-real estate collateral. State and political subdivision loans are loans to state and local municipalities for capital and operating expenses or tax free loans used to finance commercial development.



Management considers other commercial loans, other agricultural loans, state and political subdivision loans, commercial real estate loans and agricultural real estate loans which are 90 days or more past due to be impaired. Management will also consider a loan impaired based on other factors it becomes aware of, including the customer's results of operations and cash flows or if the loan is modified in a troubled debt restructuring. In addition, certain residential mortgages, home equity and consumer loans that are cross collateralized with commercial relationships that are determined to be impaired may also be classified as impaired. Impaired loans are analyzed to determine if it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allocation of the allowance for loan losses or a charge-off to the allowance for loan losses.

The following table includes the recorded investment and unpaid principal balances for impaired financing receivables by class, excluding PCI loans, with the associated allowance amount, if applicable (in thousands):

	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
March 31, 2018					
Real estate loans:					
Mortgages	\$ 1,227	\$ 268	\$ 870	\$ 1,138	\$ 22
Home Equity	112	39	57	96	16
Commercial	16,625	12,589	1,360	13,949	170
Agricultural	3,824	3,682	136	3,818	5
Construction	-	-	-	-	-
Consumer	-	-	-	-	-
Other commercial loans	4,655	3,721	418	4,139	184
Other agricultural loans	1,419	1,249	131	1,380	11
State and political subdivision loans	-	-	-	-	-
Total	\$ 27,862	\$ 21,548	\$ 2,972	\$ 24,520	\$ 408
December 31, 2017					
Real estate loans:					
Mortgages	\$ 1,055	\$ 273	\$ 700	\$ 973	\$ 47
Home Equity	92	40	52	92	9
Commercial	16,363	13,154	710	13,864	94
Agricultural	5,231	3,283	618	3,901	3
Construction	-	-	-	-	-
Consumer	10	2	6	8	-
Other commercial loans	4,739	3,766	431	4,197	231
Other agricultural loans	1,397	1,238	125	1,363	26
State and political subdivision loans	-	-	-	-	-
Total	\$ 28,887	\$ 21,756	\$ 2,642	\$ 24,398	\$ 410

The following tables includes the average balance of impaired financing receivables by class and the income recognized on these receivables for the three month periods ended March 31, 2018 and 2017(in thousands):

	For the Three Months Ended March 31, 2018			March 31, 2017		
	Average Recorded Investmen	Interest Income Recognized	Interest Income Recognized Cash Basis	Average Recorded Investmen	Interest Income Recognized	Interest Income Recognized Cash Basis
Real estate loans:						
Mortgages	\$1,023	\$ 4	\$ -	\$894	\$ 3	\$ -
Home Equity	107	1	-	56	1	-
Commercial	13,795	122	5	5,793	24	3
Agricultural	4,086	51	-	3,382	31	-
Construction	-	-	-	-	-	-
Consumer	4	-	-	1	-	-
Other commercial loans	4,156	26	-	5,597	40	10
Other agricultural loans	1,370	10	-	1,627	23	-
State and political subdivision loans	-	-	-	-	-	-
Total	\$24,541	\$ 214	\$ 5	\$17,350	\$ 122	\$ 13

#### Credit Quality Information

For commercial real estate, agricultural real estate, construction, other commercial, other agricultural and state and political subdivision loans, management uses a nine grade internal risk rating system to monitor credit quality. The first five categories are considered not criticized and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The definitions of each rating are defined below:

Pass (Grades 1-5) – These loans are to customers with credit quality ranging from an acceptable to very high quality and are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.

Special Mention (Grade 6) – This loan grade is in accordance with regulatory guidance and includes loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard (Grade 7) – This loan grade is in accordance with regulatory guidance and includes loans that have a well-defined weakness based on objective evidence and be characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful (Grade 8) – This loan grade is in accordance with regulatory guidance and includes loans that have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

Loss (Grade 9) – This loan grade is in accordance with regulatory guidance and includes loans that are considered uncollectible, or of such value that continuance as an asset is not warranted.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay the loan as agreed, the Company's loan rating process includes several layers of internal and external oversight. The Company's loan officers are responsible for the timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under the supervision of management. All commercial and agricultural loans are reviewed annually to ensure the appropriateness of the loan grade. In addition, the Company engages an external consultant on at least an annual basis to 1) review a minimum of 50% of the dollar volume of the commercial loan portfolio on an annual basis, 2) review new loans originated for over \$1.0 million in the last year, 3) review a majority of borrowers with commitments greater than or equal to \$1.0 million, 4) review selected loan relationships over \$750,000 which are over 30 days past due or classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate.



Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

The following tables represent credit exposures by internally assigned grades as of March 31, 2018 and December 31, 2017 (in thousands):

March 31, 2018	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	\$294,894	\$15,387	\$9,981	\$119	\$-	\$320,381
Agricultural	231,711	11,766	5,233	-	-	248,710
Construction	22,108	-	131	-	-	22,239
Other commercial loans	70,850	862	3,095	123	-	74,930
Other agricultural loans	38,697	341	1,358	-	-	40,396
State and political subdivision loans						
	89,480	-	10,581	-	-	100,061
Total	\$747,740	\$28,356	\$30,379	\$242	\$-	\$806,717

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	\$281,742	\$15,029	\$11,271	\$42	\$-	\$308,084
Agricultural	222,198	11,538	6,221	-	-	239,957
Construction	13,364	-	138	-	-	13,502
Other commercial loans	67,706	615	3,567	125	-	72,013
Other agricultural loans	34,914	1,325	1,570	-	-	37,809
State and political subdivision loans						
	94,125	-	10,612	-	-	104,737
Total	\$714,049	\$28,507	\$33,379	\$167	\$-	\$776,102

For residential real estate mortgages, home equity and consumer loans, credit quality is monitored based on whether the loan is performing or non-performing, which is typically based on the aging status of the loan and payment activity, unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. Non-performing loans include those loans that are considered nonaccrual, described in more detail below, and all loans past due 90 or more days and still accruing. The following table presents the recorded investment in those loan classes based on payment activity as of March 31, 2018 and December 31, 2017 (in thousands):

March 31, 2018	Performing	Non-performing	PCI	Total
Real estate loans:				
Mortgages	\$154,274	\$1,501	\$31	\$155,806
Home Equity	59,444	99	-	59,543
Consumer	9,635	37	-	9,672
Total	\$223,353	\$1,637	\$31	\$225,021

December 31, 2017	Performing	Non-performing	PCI	Total
Real estate loans:				
Mortgages	\$152,820	\$1,492	\$33	\$154,345
Home Equity	60,022	112	-	60,134
Consumer	9,895	49	-	9,944
Total	\$222,737	\$1,653	\$33	\$224,423

Aging Analysis of Past Due Financing Receivables

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table includes an aging analysis of the recorded investment of past due financing receivables as of March 31, 2018 and December 31, 2017 (in thousands):

14

---

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	PCI	Total Financing Receivables	90 Days or Greater and Accruing
March 31, 2018								
Real estate loans:								
Mortgages	\$425	\$281	\$911	\$1,617	\$154,158	\$31	\$155,806	\$ 44
Home Equity	186	54	74	314	59,229	-	59,543	-
Commercial	4,276	241	4,647	9,164	309,795	1,422	320,381	-
Agricultural	112	-	159	271	247,750	689	248,710	-
Construction	-	-	127	127	22,112	-	22,239	-
Consumer	104	44	25	173	9,499	-	9,672	7
Other commercial loans	584	47	2,597	3,228	71,260	442	74,930	378
Other agricultural loans	91	36	-	127	40,269	-	40,396	-
State and political subdivision loans	-	-	-	-	100,061	-	100,061	-
Total	\$5,778	\$703	\$8,540	\$15,021	\$1,014,133	\$2,584	\$1,031,738	\$ 429
Loans considered non-accrual	\$375	\$446	\$8,111	\$8,932	\$2,501	\$-	\$11,433	
Loans still accruing	5,403	257	429	6,089	1,011,632	2,584	1,020,305	
Total	\$5,778	\$703	\$8,540	\$15,021	\$1,014,133	\$2,584	\$1,031,738	
December 31, 2017								
Real estate loans:								
Mortgages	\$996	\$362	\$810	\$2,168	\$152,144	\$33	\$154,345	\$ 218
Home Equity	277	86	78	441	59,693	-	60,134	-
Commercial	1,353	1,010	3,865	6,228	300,396	1,460	308,084	162
Agricultural	242	-	205	447	238,808	702	239,957	30
Construction	-	-	133	133	13,369	-	13,502	-
Consumer	53	33	49	135	9,809	-	9,944	7
Other commercial loans	132	-	2,372	2,504	69,066	443	72,013	32
Other agricultural loans	-	42	106	148	37,661	-	37,809	106
State and political subdivision loans	-	-	-	-	104,737	-	104,737	-
Total	\$3,053	\$1,533	\$7,618	\$12,204	\$985,683	\$2,638	\$1,000,525	\$ 555
Loans considered non-accrual	\$816	\$281	\$7,063	\$8,160	\$2,011	\$-	\$10,171	
Loans still accruing	2,237	1,252	555	4,044	983,672	2,638	990,354	
Total	\$3,053	\$1,533	\$7,618	\$12,204	\$985,683	\$2,638	\$1,000,525	

Nonaccrual Loans

Loans are considered for non-accrual status upon reaching 90 days delinquency, although the Company may be receiving partial payments of interest and partial repayments of principal on such loans or if full payment of principal and interest is not expected. Additionally, if management is made aware of other information including bankruptcy, repossession, death, or legal proceedings, the loan may be placed on non-accrual status. If a loan is 90 days or more past due and is well secured and in the process of collection, it may still be considered accruing.

The following table reflects the financing receivables, excluding PCI loans, on non-accrual status as of March 31, 2018 and December 31, 2017, respectively. The balances are presented by class of financing receivable (in thousands):

15

---

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

	March 31, 2018	December 31, 2017
Real estate loans:		
Mortgages	\$ 1,458	\$ 1,274
Home Equity	98	112
Commercial	6,372	5,192
Agricultural	194	175
Construction	127	133
Consumer	30	42
Other commercial loans	2,494	2,637
Other agricultural loans	660	606
State and political subdivision	-	-
	\$ 11,433	\$ 10,171

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a Troubled Debt Restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to structure more affordable terms before their loan reaches nonaccrual status. These restructured terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of interest or principal, or both, management measures any impairment on the restructuring by calculating the present value of the revised loan terms and comparing this balance to the Company's investment in the loan prior to the restructuring. As these loans are individually evaluated, they are excluded from pooled portfolios when calculating the allowance for loan and lease losses and a separate allocation within the allowance for loan and lease losses is provided. Management continually evaluates loans that are considered TDRs, including payment history under the modified loan terms, the borrower's ability to continue to repay the loan based on continued evaluation of their operating results and cash flows from operations. Based on this evaluation management would no longer consider a loan to be a TDR when the relevant facts support such a conclusion. As of March 31, 2018 and December 31, 2017, included within the allowance for loan losses are reserves of \$37,000 and \$41,000 respectively, that are associated with loans modified as TDRs.

Loan modifications that are considered TDRs completed during the three months ended March 31, 2018 and 2017 were as follows (dollars in thousands):

		For the Three Months Ended March 31, 2018			
		Pre-modification		Post-Modification	
Number of contracts		Outstanding	Recorded	Outstanding	Recorded
Interest Term Modification		Interest Modification	Term Modification	Interest Modification	Term Modification
Real estate loans:					
Mortgages	- 1	\$ -	\$ 7	\$ -	\$ 7
Total	- 1	\$ -	\$ 7	\$ -	\$ 7

		For the Three Months Ended March 31, 2017	
Number of contracts		Pre-modification	Post-Modification
		Outstanding	Outstanding
		Recorded	Recorded



	Interest Term Modification	Investment Interest Term Modification	Investment Interest Term Modification
Real estate loans:			
Commercial	- 2	\$ - \$ 703	\$ - \$ 703
Total	- 2	\$ - \$ 703	\$ - \$ 703

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism on modified loans occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. There were no loans that were modified as TDRs during each 12-month period prior to the current reporting periods, which began January 1, 2018 and 2017 (3 month periods), respectively, that subsequently defaulted during these reporting periods.

Allowance for Loan Losses

The following table segregates the allowance for loan losses (ALLL) into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of March 31, 2018 and December 31, 2017, respectively (in thousands):

	March 31, 2018			December 31, 2017		
	Individually evaluated for impairment	Collectively evaluated for impairment	Total	Individually evaluated for impairment	Collectively evaluated for impairment	Total
Real estate loans:						
Residential	\$38	\$ 1,039	\$1,077	\$56	\$ 993	\$1,049
Commercial	170	3,836	4,006	94	3,773	3,867
Agricultural	5	3,335	3,340	3	3,140	3,143
Construction	-	39	39	-	23	23
Consumer	-	123	123	-	124	124
Other commercial loans	184	1,089	1,273	231	1,041	1,272
Other agricultural loans	11	521	532	26	466	492
State and political subdivision loans	-	789	789	-	816	816
Unallocated	-	408	408	-	404	404
Total	\$408	\$ 11,179	\$11,587	\$410	\$ 10,780	\$11,190

The following tables roll forward the balance of the ALLL by portfolio segment for the three month periods ended March 31, 2018 and 2017, respectively (in thousands):

	For the three months ended March 31, 2018				Balance at March 31, 2018
	Balance at December 31, 2017	Charge-offs	Recoveries	Provision	
Real estate loans:					
Residential	\$1,049	\$ (15 )	\$ -	\$ 43	\$1,077
Commercial	3,867	-	-	139	4,006
Agricultural	3,143	-	-	197	3,340
Construction	23	-	-	16	39
Consumer	124	(13 )	10	2	123
Other commercial loans	1,272	(45 )	3	43	1,273
Other agricultural loans	492	(43 )	-	83	532
State and political subdivision loans	816	-	-	(27 )	789
Unallocated	404	-	-	4	408
Total	\$11,190	\$ (116 )	\$ 13	\$ 500	\$11,587



Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

	For the three months ended March 31, 2017				
	Balance				Balance
	at				at
	December				March
	31,				31,
	2016	Charge-offs	Recoveries	Provision	2017
Real estate loans:					
Residential	\$1,064	\$ (45 )	\$ -	\$ 23	\$ 1,042
Commercial	3,589	(41 )	4	113	3,665
Agricultural	1,494			458	1,952
Construction	47	-	-	(1 )	46
Consumer	122	(28 )	10	19	123
Other commercial loans	1,327	-	9	(121 )	1,215
Other agricultural loans	312	(5 )		(1 )	306
State and political subdivision loans	833	-	-	(9 )	824
Unallocated	98	-	-	134	232
Total	\$8,886	\$ (119 )	\$ 23	\$ 615	\$9,405

The Company allocates the ALLL based on the factors described below, which conform to the Company's loan classification policy and credit quality measurements. In reviewing risk within the Company's loan portfolio, management has determined there to be several different risk categories within the loan portfolio. The ALLL consists of amounts applicable to: (i) residential real estate loans; (ii) residential real estate home equity loans; (iii) commercial real estate loans; (iv) agricultural real estate loans; (v) real estate construction loans; (vi) other commercial and agricultural loans; (vii) consumer loans; (viii) other agricultural loans and (ix) state and political subdivision loans. Factors considered in this process include general loan terms, collateral, and availability of historical data to support the analysis. Historical loss percentages are calculated and used as the basis for calculating allowance allocations. Certain qualitative factors are evaluated to determine additional inherent risks in the loan portfolio, which are not necessarily reflected in the historical loss percentages. These factors are then added to the historical allocation percentage to get the adjusted factor to be applied to non-classified loans. The following qualitative factors are analyzed:

- Level of and trends in delinquencies and impaired/classified loans
- § Change in volume and severity of past due loans
- § Volume of non-accrual loans
- § Volume and severity of classified, adversely or graded loans;
- Level of and trends in charge-offs and recoveries;
- Trends in volume, terms and nature of the loan portfolio;
- Effects of any changes in risk selection and underwriting standards and any other changes in lending and recovery policies, procedures and practices;
- Changes in the quality of the Company's loan review system;
- Experience, ability and depth of lending management and other relevant staff;
- National, state, regional and local economic trends and business conditions
- § General economic conditions
- § Unemployment rates
- § Inflation rate/ Consumer Price Index
- § Changes in values of underlying collateral for collateral-dependent loans;
- Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses;
- Existence and effect of any credit concentrations, and changes in the level of such concentrations; and
- Any change in the level of board oversight.

The Company analyzes its loan portfolio each quarter to determine the adequacy of its ALLL.

Loans determined to be TDRs are impaired and for purposes of estimating the ALLL must be individually evaluated for impairment. In calculating the impairment, the Company calculates the present value utilizing an analysis of discounted cash flows. If the present value calculated is below the recorded investment of the loan, impairment is recognized by a charge to the provision for loan and lease losses and a credit to the ALLL.

18

---

For the three months ended March 31, 2018, the allowance for residential real estate increased in general reserves for pooled loans as a result of increased loss rates reflected in the charge-offs for the three month period, as well as higher loan balances. The increase was offset by a decrease in the specific reserve for individually evaluated residential loans. This was represented as an increase to the provision. The allowance for commercial real estate was increased in general reserves due to growth in the commercial real estate loan portfolio. It was also impacted by an increase in specific reserves during the quarter. This was represented as an increase in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances. The result of this growth was represented as an increase in the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. The result of these changes was represented as an increase in the provision.

For the three months ended March 31, 2017, the allowance for commercial real estate was increased in general reserves due to growth in the loan portfolio. This was offset by a decrease in qualitatives associated with the decrease in classified and past due loans. The result of these changes was represented as an increase in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances. It was also impacted by the classified and past due loan trend in the agricultural real estate portfolio. The result of these changes was represented as an increase in the provision. The allowance for other commercial loans was decreased as a result of a lower specific allowance as well as lower classified and past due loans. This was represented by a decrease to the provision.

#### Foreclosed Assets Held For Sale

Foreclosed assets acquired in settlement of loans are carried at fair value, less estimated costs to sell, and are included in other assets on the Consolidated Balance Sheet. As of March 31, 2018 and December 31, 2017, included with other assets are \$952,000 and \$1,119,000, respectively, of foreclosed assets. As of March 31, 2018, included within the foreclosed assets are \$136,000 of consumer residential mortgages that were foreclosed on or received via a deed in lieu transaction prior to the period end. As of March 31 2018, the Company has initiated formal foreclosure proceedings on \$1,776,000 of consumer residential mortgages, which have not yet been transferred into foreclosed assets.

#### Note 7 – Goodwill and Other Intangible Assets

The following table provides the gross carrying value and accumulated amortization of intangible assets as of March 31, 2018 and December 31, 2017 (in thousands):

	March 31, 2018			December 31, 2017		
	Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
Amortized intangible assets (1):						
MSRs	\$ 1,634	\$ (961)	) \$ 673	\$ 1,605	\$ (912)	) \$ 693
Core deposit intangibles	1,786	(655)	) 1,131	1,786	(586)	) 1,200
Covenant not to compete	125	(73)	) 52	125	(65)	) 60
Total amortized intangible assets	\$ 3,545	\$ (1,689)	) \$ 1,856	\$ 3,516	\$ (1,563)	) \$ 1,953
Unamortized intangible assets:						
Goodwill	\$ 23,296			\$ 23,296		

(1) Excludes fully amortized intangible assets

The following table provides the current year and estimated future amortization expense for amortized intangible assets for the next five years. We based our projections of amortization expense shown below on existing asset balances at March 31, 2018. Future amortization expense may vary from these projections (in thousands):



	MSRs	Core deposit intangibles	Covenant not to compete	Total
Three months ended March 31, 2018 (actual)	\$ 49	\$ 69	\$ 8	\$ 126
Three months ended March 31, 2017 (actual)	\$ 47	\$ 68	\$ 8	\$ 123
Estimate for year ended December 31, Remaining 2018	135	196	23	354
2019	153	230	29	412
2020	120	197	-	317
2021	91	165	-	256
2022	67	133	-	200

#### Note 8 – Federal Home Loan Bank Stock

As a member of the FHLB of Pittsburgh, the Bank is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. As of March 31, 2018 and December 31, 2017, the Bank's investment in FHLB stock was \$5,942,000 and \$6,021,000, respectively. The stock does not have a readily determinable fair value and, as such, is classified as restricted stock, carried at cost and evaluated by management for impairment. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) a significant decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB's regulatory capital ratios are sufficient, liquidity appears adequate, new shares of FHLB stock continue to exchange hands at the \$100 par value and the FHLB has repurchased shares of excess capital stock from its members and has paid a quarterly cash dividend.

#### Note 9 – Repurchase Agreements

We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor collateral levels on a continuous basis. We may be required to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agents.

The value of the collateral segmented by the remaining contractual maturity of the repurchase agreements in the Consolidated Balance Sheets as of March 31, 2018 and December 31, 2017 is presented in the following tables (in thousands):

	Remaining Contractual Maturity of the Agreements				Total
	Overnight and Continuous	Up to 30 - 30 Days	Greater than 90 Days		
March 31, 2018 Repurchase Agreements: U.S. agency securities	\$18,945	\$ -	\$ -	\$2,009	\$20,954



Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Total carrying value of collateral pledged	\$18,945	\$ -	\$ -	\$2,009	\$20,954
Total liability recognized for repurchase agreements					\$14,683
December 31, 2017					
Repurchase Agreements:					
U.S. agency securities	\$16,027	\$ -	\$ -	\$2,035	\$18,062
Total carrying value of collateral pledged	\$16,027	\$ -	\$ -	\$2,035	\$18,062
Total liability recognized for repurchase agreements					\$14,989

## Note 10 - Employee Benefit Plans

For additional detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 11 of the Company's Consolidated Financial Statements included in the 2017 Annual Report on Form 10-K.

## Noncontributory Defined Benefit Pension Plan

The Bank sponsors a trustee noncontributory defined benefit pension plan ("Pension Plan") covering substantially all employees and officers hired prior to January 1, 2007. Additionally, the Bank assumed the noncontributory defined benefit pension plan of FNB when it was acquired. The FNB plan was frozen prior to the acquisition and therefore, no additional benefits will accrue for employees covered under that plan. These two plans are collectively referred to herein as "the Plans." The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plans' actuary. Any employee with a hire date of January 1, 2007 or later is not eligible to participate in the Pension Plan.

In lieu of the Pension Plan, employees with a hire date of January 1, 2007 or later are eligible to receive, after meeting certain length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

For employees who are eligible to participate in the Pension Plan, the Pension Plan requires benefits to be paid to eligible employees based primarily upon age and compensation rates during employment. Upon retirement or other termination of employment, employees can elect either an annuity benefit or a lump sum distribution of vested benefits in the Pension Plan.

The following sets forth the components of net periodic benefit costs of the Pension Plan and the line item on the Consolidated Statement of Income where such amounts are included, for the three months ended March 31, 2018 and 2017, respectively (in thousands):

	Three Months Ended		Affected line item on the Consolidated Statement of income
	March 31, 2018	2017	
Service cost	\$89	\$91	Salary and employee benefits
Interest cost	163	167	Other expenses
Expected return on plan assets	(344)	(274)	Other expenses
Net amortization and deferral	46	60	Other expenses
Net periodic(benefit) cost	\$(46 )	\$44	

The Bank does not expect to make any contributions to the Pension Plans during 2018.

## Defined Contribution Plan

The Company sponsors a voluntary 401(k) savings plan which eligible employees can elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). Under the plan, the Company also makes required contributions on behalf of the eligible employees. Contributions by the Company totaled \$111,000 and \$99,000 for the three months ended March 31, 2018 and 2017, respectively.

## Directors' Deferred Compensation Plan

The Company's directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. At March 31, 2018 and December 31, 2017, an obligation of \$896,000 and \$928,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Amounts included in interest expense on the deferred amounts totaled \$5,000 for each of the three months ended March 31, 2018 and 2017, respectively.

### Restricted Stock Plan

The Company maintains a Restricted Stock Plan (the "Plan") whereby employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company's common stock and are subject to certain vesting requirements including continuous employment or service with the Company. In April of 2016, the Company's shareholders authorized a total of 150,000 shares of the Company's common stock to be made available under the Plan. As of March 31, 2018, 141,408 shares remain available to be issued under the Plan. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

The following table details the vesting, awarding and forfeiting of restricted shares during the three month period ended March 31, 2018:

	Three months	
	Unvested	Weighted Average Market Price
	Shares	Price
Outstanding, beginning of period	8,783	\$ 51.20
Granted	-	-
Forfeited	-	-
Vested	(92 )	52.05
Outstanding, end of period	8,691	\$ 51.19

Compensation cost related to restricted stock is recognized, based on the market price of the stock at the grant date, over the vesting period. Compensation expense related to restricted stock was \$56,000 and \$50,000 for the three months ended March 31, 2018 and 2017, respectively. At March 31, 2018, the total compensation cost related to nonvested awards that has not yet been recognized was \$445,000, which is expected to be recognized over the next three years.

### Supplemental Executive Retirement Plan

The Company maintains a non-qualified supplemental executive retirement plan ("SERP") for certain executives to compensate those executive participants in the Company's noncontributory defined benefit pension plan whose benefits are limited by compensation limitations under current tax law. At March 31, 2018 and December 31, 2017, an obligation of \$1,619,000 and \$1,571,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Expenses related to this plan totaled \$48,000 and \$28,000 for the three months ended March 31, 2018 and 2017, respectively.

### Salary Continuation Plan

The Company maintains a salary continuation plan for certain employees retained through the acquisition of FNB or that were formerly employed by FNB. At March 31, 2018 and December 31 2017, an obligation of \$713,000 and \$716,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Expenses related to this plan totaled \$13,000 for each of the three months ended March 31, 2018 and 2017.

### Continuation of Life Insurance Plan

The Company, as part of the acquisition of FNB, has promised a continuation of certain split-dollar life insurance policies that provide coverage to certain persons post-retirement. U.S. generally accepted accounting principles

require the recording of post-retirement costs and a liability equal to the present value of the cost of post-retirement insurance during the person's term of service. The estimated present value of future benefits to be paid totaled \$598,000 and \$578,000 as of March 31, 2018 and December 31, 2017, respectively, which is included in other liabilities in the Consolidated Balance Sheet. Expenses related to this plan totaled \$33,000 and \$19,000 for the three months ended March 31, 2018 and 2017, respectively.

## Note 11 – Accumulated Comprehensive Income (Loss)

The following tables present the changes in accumulated other comprehensive income (loss) by component net of tax for the three months ended March 31, 2018 and 2017 (in thousands):

	Three months ended March 31, 2018		
	Unrealized gain (loss) on Defined available Benefit for sale Pension securities Items		
	(a)	(a)	Total
Balance as of December 31, 2017	\$(269 )	\$(3,129 )	\$(3,398)
Change in accounting policy – ASU 2016-01	1	-	1
Other comprehensive income (loss) before reclassifications (net of tax)	(1,617)	-	(1,617)
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	-	37	37
Net current period other comprehensive income (loss)	(1,617)	37	(1,580)
Balance as of March 31, 2018	\$(1,885)	\$(3,092 )	\$(4,977)

	Three months ended March 31, 2017		
	Unrealized gain (loss) on Defined available Benefit for sale Pension securities Items		
	(a)	(a)	Total
Balance as of December 31, 2016	\$1,306	\$(2,698 )	\$(1,392)
Other comprehensive income (loss) before reclassifications (net of tax)	46	-	46
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	(114 )	39	(75 )
Net current period other comprehensive income (loss)	(68 )	39	(29 )
Balance as of March 31, 2017	\$1,238	\$(2,659 )	\$(1,421)

The following table presents the significant amounts reclassified out of each component of accumulated other comprehensive income for the three months ended March 31, 2018 and 2017 (in thousands):

	Amount reclassified from accumulated comprehensive income (loss) (a)	Affected line item in the Consolidated Statement of Income
Details about accumulated other comprehensive income (loss)		

	Three Months Ended March 31, 2018		2017
Unrealized gains and losses on available for sale securities	\$ -	\$ 172	Investment securities gains, net
	-	(58 )	Provision for income taxes
	\$ -	\$ 114	Net of tax
Defined benefit pension items			
	\$ (46 )	\$ (60 )	Salaries and employee benefits
	9	21	Provision for income taxes
	\$ (37 )	\$ (39 )	Net of tax
Total reclassifications	\$ (37 )	\$ 75	

Note 12 – Fair Value Measurements

The Company has established a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by this hierarchy are as follows:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, the Company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. Our valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and/or quarterly valuation process.

#### Assets and Liabilities Required to be Measured at Fair Value on a Recurring Basis

The fair values of securities available for sale are determined by quoted prices in active markets, when available, and classified as Level I. If quoted market prices are not available, the fair value is determined by a matrix pricing, which is a mathematical technique, widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities and classified as Level II. The fair values consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

The following tables present the assets and liabilities reported on the Consolidated Balance Sheet at their fair value on a recurring basis as of March 31, 2018 and December 31, 2017 by level within the fair value hierarchy (in thousands). Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

March 31, 2018	Level			Total
	Level I	Level II	III	
Fair value measurements on a recurring basis:				
Assets				
Equity securities in financial institutions	\$188	\$-	\$ -	\$188
Available for sale securities:				
U.S. Agency securities	-	99,186	-	99,186
U.S. Treasury securities	33,112	-	-	33,112
Obligations of state and political subdivisions	-	71,532	-	71,532
Corporate obligations	-	3,050	-	3,050
Mortgage-backed securities in government sponsored entities	-	44,460	-	44,460





December 31, 2017	Level			Total
	Level I	Level II	III	
Fair value measurements on a recurring basis:				
Available for sale securities:				
U.S. Agency securities	\$-	\$98,887	\$ -	\$98,887
U.S. Treasuries securities	28,604	-	-	28,604
Obligations of state and political subdivisions	-	79,090	-	79,090
Corporate obligations	-	3,083	-	3,083
Mortgage-backed securities in government sponsored entities	-	45,027	-	45,027
Equity securities in financial institutions	91	-	-	91

#### Assets and Liabilities Required to be Measured and Reported at Fair Value on a Nonrecurring Basis

Assets measured at fair value on a nonrecurring basis as of March 31, 2018 and December 31, 2017 are included in the table below (in thousands):

March 31, 2018	Level	Level	Level	Total
	I	II	III	
Impaired Loans	\$ -	\$ -	\$2,425	\$2,425
Other real estate owned	-	-	844	844

December 31, 2017				
	Level	Level	Level	Total
	I	II	III	
Impaired Loans	\$ -	\$ -	\$1,569	\$1,569
Other real estate owned	-	-	1,024	1,024

Impaired Loans - The Company has measured impairment on impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral dependent loan is less than the carrying amount of the loan a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the table above as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is not included in the table above as it is not currently being carried at its fair value. The fair values above excluded estimated selling costs of \$238,000 and \$163,000 at March 31, 2018 and December 31, 2017, respectively.

Other Real Estate Owned (OREO) – OREO is carried at the lower of cost or fair value, which is measured at the date of foreclosure. If the fair value of the collateral exceeds the carrying amount of the loan, no charge-off or adjustment is necessary, the loan is not considered to be carried at fair value, and is therefore not included in the table above. If the fair value of the collateral is less than the carrying amount of the loan, management will charge the loan down to its estimated realizable value. The fair value of OREO is based on the appraised value of the property, which is generally unadjusted by management and is based on comparable sales for similar properties in the same geographic region as the subject property, and is included in the above table as a Level II measurement. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. In these cases, the loans are categorized in the above table as Level III measurement since these adjustments are considered to be unobservable inputs. Income and expenses from operations and further declines in the fair value of the collateral subsequent to foreclosure are included in net expenses from OREO.

The following table provides a listing of the significant unobservable inputs used in the fair value measurement process for items valued utilizing Level III techniques (dollars in thousands).

25

---

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

	Fair Value	Valuation Technique(s)	Unobservable input	Range	Weighted average
March 31, 2018 Impaired Loans	\$2,425	Appraised Collateral Values	Discount for time since appraisal	0-100 %	33.77 %
			Selling costs	5%-11 %	8.47 %
			Holding period	0 - 24 months	11.15 months
Other real estate owned	844	Appraised Collateral Values	Discount for time since appraisal	17-35 %	24.57 %
December 31, 2017 Impaired Loans	1,569	Appraised Collateral Values	Discount for time since appraisal	0-100 %	30.83 %
			Selling costs	5%-9 %	8.35 %
			Holding period	6 - 12 months	11 months
Other real estate owned	1,024	Appraised Collateral Values	Discount for time since appraisal	15-65 %	26.26 %

Financial Instruments Not Required to be Measured or Reported at Fair Value

The carrying amount and fair value of the Company's financial instruments that are not required to be measured or reported at fair value are as follows (in thousands):

	Carrying		Level		
	Amount	Fair Value	Level I	II	Level III
March 31, 2018					
Financial assets:					
Cash and due from banks	\$12,475	\$12,475	\$12,475	\$ -	\$-
Interest bearing time deposits with other banks	10,532	10,543	-	-	10,543
Loans held for sale	233	233	233	-	-
Net loans	1,020,151	1,001,421	-	-	1,001,421
Bank owned life insurance	27,035	27,035	27,035	-	-
Regulatory stock	6,705	6,705	6,705	-	-
Accrued interest receivable	4,283	4,283	4,283	-	-
Financial liabilities:					
Deposits	\$1,115,153	\$1,110,055	\$847,737	\$ -	\$262,318
Borrowed funds	124,121	122,822	87,413	-	35,409
Accrued interest payable	867	867	867	-	-
December 31, 2017					
Financial assets:					
Cash and due from banks	\$18,517	\$18,517	\$18,517	\$ -	\$-
Interest bearing time deposits with other banks	10,283	10,287	-	-	10,287
Loans held for sale	1,439	1,439	1,439	-	-
Net loans	989,335	981,238	-	-	981,238
Bank owned life insurance	26,883	26,883	26,883	-	-
Regulatory stock	6,784	6,784	6,784	-	-
Accrued interest receivable	4,196	4,196	4,196	-	-

Financial liabilities:

Deposits	\$1,104,943	\$1,101,583	\$838,490	\$ -	\$263,093
Borrowed funds	114,664	113,452	77,650	-	35,802
Accrued interest payable	897	897	897	-	-

## Note 13 – Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments, which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which addresses eight specific cash flow issues with the objective of reducing diversity in practice. Among these include recognizing cash payments for debt prepayment or debt extinguishment as cash outflows for financing activities; cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage; and cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash inflows from investing activities while the cash payments for premiums on bank-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively

for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. This Update did not have a significant impact on the Company's statement of cash flows.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740), which requires recognition of current and deferred income taxes resulting from an intra-entity transfer of any asset (excluding inventory) when the transfer occurs. Consequently, the amendments in this Update eliminate the exception for an intra-entity transfer of an asset other than inventory. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those annual reporting periods. For all other entities, the amendments are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements. The amendments in this Update should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. This Update did not have a significant impact on the Company's financial statements.

In October 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230), which requires that a statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments in this Update should be applied using a retrospective transition method to each period presented. This Update did not have a significant impact on the Company's financial statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805), Clarifying the Definition of a Business, which provides a more robust framework to use in determining when a set of assets and activities (collectively referred to as a "set") is a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated. Public business entities should apply the amendments in this Update to annual periods beginning after December 15, 2017, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The amendments in this Update should be applied prospectively on or after the effective date. This Update did not have a significant impact on the Company's financial statements.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in this Update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. A public business entity that is a U.S. Securities and Exchange Commission (SEC) filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities, that are adopting the amendments in this Update should do so for their annual or any interim



goodwill impairment tests in fiscal years beginning after December 15, 2021. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2017, the FASB issued ASU 2017-07, Compensation—Retirement Benefits (Topic 715). The amendments in this Update require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost as defined in paragraphs 715-30-35-4 and 715-60-35-9 are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are used to present the other components of net benefit cost, that line item or items must be appropriately described. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed. The amendments in this Update are effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The Company has adopted this standard and has retrospectively applied the presentation of the service cost component and the other components of net periodic pension cost and net periodic postretirement benefit cost in the consolidated statement of income.

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20). The amendments in this Update shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. This Update is not expected to have a significant impact on the Company's financial statements.

In July 2017, the FASB issued ASU 2017-11, Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), and Derivative and Hedging (Topic 815). The amendments in Part I of this Update change the classification analysis of certain equity-linked financial instruments (or embedded features) with down-round features. When determining whether certain financial instruments should be classified as liabilities or equity instruments, a down-round feature no longer precludes equity classification when assessing whether the instrument is indexed to an entity's own stock. The amendments also clarify existing disclosure requirements for equity-classified instruments. As a result, a freestanding equity-linked financial instrument (or embedded conversion option) no longer would be accounted for as a derivative liability at fair value as a result of the existence of a down-round feature. For freestanding equity classified financial instruments, the amendments require entities that present earnings per share (EPS) in accordance with Topic 260 to recognize the effect of the down-round feature when it is triggered. That effect is treated as a dividend and as a reduction of income available to common shareholders in basic EPS. Convertible instruments with embedded conversion options that have down-round features are now subject to the specialized guidance for contingent beneficial conversion features (in Subtopic 470-20, Debt—Debt with Conversion and Other Options), including related EPS guidance (in Topic 260). The amendments in Part II of this Update recharacterize the indefinite deferral of certain provisions of Topic 480 that now are presented as pending content in the Accounting Standards Codification, to a scope exception. Those amendments do not have an accounting effect. For public business entities, the amendments in Part I of this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments in Part I of this Update are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments in Part I of this Update should be applied either retrospectively to outstanding financial instruments with a down-round feature by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in

which the pending content that links to this paragraph is effective or retrospectively to outstanding financial instruments with a down-round feature for each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10. The amendments in Part II of this Update do not require any transition guidance because those amendments do not have an accounting effect. This Update is not expected to have a significant impact on the Company's financial statements.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 850), the objective of which is to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. In addition, the amendments in this Update make certain targeted improvements to simplify the application and disclosure of the hedge accounting guidance in current general accepted accounting principles. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early application is permitted in any period after issuance. For cash flow and net investment hedges existing at the date of adoption, an entity should apply a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year that an entity adopts the amendments in this Update. The amended presentation and disclosure guidance is required only prospectively. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In January 2018, the FASB issued ASU 2018-01, Leases (Topic 842), which provides an optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current lease guidance in Topic 840. An entity that elects this practical expedient should evaluate new or modified land easements under Topic 842 beginning at the date the entity adopts Topic 842; otherwise, an entity should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02. This Update is not expected to have a significant impact on the Company's financial statements.

In February 2018, the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10), to clarify certain aspects of the guidance issued in ASU 2016-01. (1) An entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with Topic 820, Fair Value Measurement, through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer. Once an entity makes this election, the entity should measure all future purchases of identical or similar investments of the same issuer using a fair value method in accordance with Topic 820. (2) Adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place. (3) Remeasuring the entire value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities. (4) When the fair value option is elected for a financial liability, the guidance in paragraph 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, or 825-10, Financial Instruments—Overall. (5) Financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates. (6) The prospective transition approach for equity securities without a readily determinable fair value in the amendments in Update 2016-01 is meant only for instances in which the measurement alternative is applied. An insurance entity subject to the guidance in Topic 944, Financial Services—Insurance, should apply a prospective transition method when applying the amendments related to equity securities without readily determinable fair values. An insurance entity should apply the selected prospective transition method consistently to the entity's entire population of equity securities for which the measurement alternative is elected. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Public business entities with fiscal years beginning between December 15, 2017, and June 15, 2018, are not required to adopt these amendments until the interim period beginning after June 15, 2018, and public business entities with fiscal years beginning between June 15, 2018, and December 15, 2018, are not required to adopt these amendments before adopting the amendments in Update 2016-01. For all other entities, the effective date is the same as the effective date in Update 2016-01. All entities may early adopt these

amendments for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as they have adopted Update 2016-01. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

ASU 2018-04, Investments – Debt Securities (Topic 320) and Regulated Operations (Topic 980) - Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273, ASU 2018-04 supersedes various SEC paragraphs and adds an SEC paragraph pursuant to the issuance of Staff Accounting Bulletin No. 117.

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

Forward-Looking Statements

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 expected future results of operations of Citizens Financial Services, Inc., First Citizens Community Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use words such 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 cautions readers that the following important factors, among others, 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.  
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 financial 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 to implement strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.
- We may not be able to successfully integrate businesses we acquire or be able to fully realize the expected financial and other benefits from acquisitions.
- 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 or operating results.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices or requirements.  
We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition.
- We could also experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- 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.
- The agricultural economy is subject to extreme swings in both the costs of resources and the prices received from the sale of products, which could negatively impact our customers.
- Loan concentrations in certain industries could negatively impact financial results, if financial results or economic conditions deteriorate.
- A budget impasse in the Commonwealth of Pennsylvania could impact our asset values, liquidity and profitability as a result of either delayed or reduced funding to school districts and municipalities who are customers of the Bank.  
Companies providing support services related to the exploration and drilling of the natural gas reserves in our market area may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection, which could negatively impact our customers and, as a result, negatively impact our loan and deposit volume and loan quality. Additionally, the activities the companies providing support services related to the exploration and drilling of the natural gas reserves may be dependent on the market price of natural gas. As a result, decreases in the market price of natural gas could also negatively impact these companies, our customers.

---

Additional factors that may affect our results are discussed under "Part II – Item 1A – Risk Factors" in this report and in the Company's 2017 Annual Report on Form 10-K under "Item 1.A/ Risk Factors." Except as required by applicable law and regulation, we assume no obligation to update or revise any forward-looking statements after the date on which they are made.

## Introduction

The following is management's discussion and analysis of the financial condition and results of operations at the dates and for the periods presented in the accompanying consolidated financial statements for the Company. Our consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three months ended March 31, 2018 are not necessarily indicative of the results you may expect for the full year.

The Company currently engages in the general business of banking throughout our service area of Potter, Tioga, Clinton, Potter and Centre counties in north central Pennsylvania, Lebanon, Berks, Schuylkill and Lancaster counties in south central Pennsylvania and Allegany County in southern New York. We also have a limited branch office in Union county, Pennsylvania, which primarily serves agricultural customers in the central Pennsylvania market. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 29 banking facilities, 28 of which operate as bank branches. In Pennsylvania, the Company has full service offices located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Mansfield Wal-Mart Super Center, Mill Hall, Schuylkill Haven, Friedensburg, Mt. Aetna, Fredericksburg, Mount Joy, State College and three branches near the city of Lebanon, Pennsylvania. We also have limited branch offices in Winfield and Narvon, Pennsylvania. In New York, our office is in Wellsville.

On December 8, 2017, we closed the transaction with S&T Bank to acquire its State College, Pennsylvania office.

## Risk Management

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, reputational 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.

Reputational risk, or the risk to our business, earnings, liquidity, and capital from negative public opinion, could result from our actual or alleged conduct in a variety of areas, including legal and regulatory compliance, lending practices, corporate governance, litigation, ethical issues, or inadequate protection of customer information. We expend significant resources to comply with regulatory requirements. Failure to comply could result in reputational harm or significant legal or remedial costs. Damage to our reputation could adversely affect our ability to retain and attract new customers, and adversely impact our earnings and liquidity.





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. We cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.

### Competition

The banking industry in the Bank's service areas continue to be extremely competitive, both among commercial banks and with financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions, agricultural cooperatives and internet entities. Competition in our north central Pennsylvania market has increased as a result of other financial institutions looking to expand into new markets. With larger population centers in our central and south central markets, we experience more competition to gather deposits and to make loans than in our north central Pennsylvania market. Mortgage banking firms, financial companies, financial affiliates of industrial companies, brokerage firms, retirement fund management firms and even government agencies provide additional competition for loans and other financial services. The Bank is generally competitive with all competing financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

### Trust and Investment Services; Oil and Gas Services

Our Investment and Trust Services Division offers professional trust administration, investment management services, estate planning and administration, and custody of securities. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the Consolidated Balance Sheets since such items are not assets of the Company. Revenues and fees of the Trust Department are reflected in trust income in the Consolidated Statement of Income. As of March 31, 2018 and December 31, 2017, the Trust Department had \$122.4 million and \$122.7 million of assets under management, respectively.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc. The assets associated with these products are not included in the Consolidated Balance Sheets since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from \$156.0 million at December 31, 2017 to \$158.6 million at March 31, 2018. Fee income from the sale of these products is reflected in brokerage and insurance income in the Consolidated Statement of Income. Management believes that there are opportunities to increase non-interest income through these products and services, especially in our central and south central Pennsylvania markets.

In addition to traditional trust and investment services offered, we assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. As of March 31, 2018, customers owning 7,012 acres have signed agreements with the Bank that provide for the Bank to manage oil and gas matters related to the customers land, which may include negotiating lease payments and royalty percentages, resolving leasing issues, accounting for and ensuring the accuracy of royalty checks, distributing revenue to satisfy investment objectives and providing customized reports outlining payment and distribution information.

### Results of Operations

#### Overview of the Income Statement

The Company had net income of \$4,247,000 for the first three months of 2018 compared to \$3,303,000 for last year's comparable period, an increase of \$944,000, or 28.6%. Basic earnings per share for the first three months of 2018 were \$1.22, compared to \$0.94 last year, representing a 29.8% increase. Annualized return on assets and return on

equity for the three months of 2018 were 1.24% and 12.62%, respectively, compared with 1.08% and 10.45% for last year's comparable period.

## Net Interest Income

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

Net interest income for the first three months of 2018 was \$11,420,000, an increase of \$1,423,000, or 14.2%, compared to the same period in 2017. For the first three months of 2018, the provision for loan losses totaled \$500,000, a decrease of \$115,000 over the comparable period in 2017. Consequently, net interest income after the provision for loan losses was \$10,920,000 compared to \$9,382,000 during the first three months of 2017.

The following table sets forth the average balances of, and the interest earned or incurred on, for each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and interest rate spread created for the three months ended March 31, 2018 and 2017 on a tax equivalent basis (dollars in thousands):

35

---

Analysis of Average Balances and Interest Rates (1)						
Three Months Ended						
	March 31, 2018			March 31, 2017		
	Average	Average		Average	Average	
	Balance	Rate		Balance	Rate	
(dollars in thousands)	(1)	Interest	Rate	(1)	Interest	Rate
	\$	\$	%	\$	\$	%
<b>ASSETS</b>						
Short-term investments:						
Interest-bearing deposits at banks	8,100	5	0.25	7,643	2	0.11
Total short-term investments	8,100	5	0.25	7,643	2	0.11
Interest bearing time deposits at banks	10,311	53	2.11	6,870	33	1.97
Investment securities:						
Taxable	183,155	937	2.05	210,364	879	1.67
Tax-exempt (3)	75,288	667	3.34	90,783	1,013	4.46
Total investment securities	258,443	1,604	2.48	301,147	1,892	2.51
Loans:						
Residential mortgage loans	214,598	2,724	5.15	205,978	2,634	5.19
Construction	17,665	201	4.62	28,150	304	4.38
Commercial Loans	388,200	4,978	5.20	316,059	4,066	5.22
Agricultural Loans	283,714	3,037	4.34	169,279	1,813	4.34
Loans to state & political subdivisions	104,511	916	3.55	97,178	1,012	4.22
Other loans	9,507	183	7.79	10,495	209	8.06
Loans, net of discount (2)(3)(4)	1,018,195	12,039	4.79	827,139	10,038	4.92
Total interest-earning assets	1,295,049	13,701	4.29	1,142,799	11,965	4.25
Cash and due from banks	6,908			6,671		
Bank premises and equipment	16,481			17,007		
Other assets	54,878			56,145		
Total non-interest earning assets	78,267			79,823		
Total assets	1,373,316			1,222,622		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest-bearing liabilities:						
NOW accounts	325,937	330	0.41	310,621	240	0.31
Savings accounts	185,242	50	0.11	175,424	45	0.10
Money market accounts	145,890	245	0.68	116,889	130	0.45
Certificates of deposit	266,275	691	1.05	262,523	630	0.97
Total interest-bearing deposits	923,344	1,316	0.58	865,457	1,045	0.49
Other borrowed funds	138,613	647	1.89	68,854	258	1.52
Total interest-bearing liabilities	1,061,957	1,963	0.75	934,311	1,303	0.57
Demand deposits	164,189			147,019		
Other liabilities	12,537			14,872		
Total non-interest-bearing liabilities	176,726			161,891		
Stockholders' equity	134,633			126,420		
Total liabilities & stockholders' equity	1,373,316			1,222,622		
Net interest income		11,738			10,662	
Net interest spread (5)			3.54 %			3.68 %
Net interest income as a percentage of average interest-earning assets			3.68 %			3.78 %
Ratio of interest-earning assets to interest-bearing liabilities			122 %			122 %

- (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 21% for 2018 and 34% for 2017.
- (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 21% for the first three of 2018 and 34% for the first three months of 2017. 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 Federal statutory rate during the corresponding period. The following table represents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the periods ended March 31, 2018 and 2017(in thousands):

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

	For the Three Months Ended March 31, 2018      2017	
Interest and dividend income from investment securities and interest bearing deposits at banks (non-tax adjusted)	\$ 1,522	\$ 1,583
Tax equivalent adjustment	140	344
Interest and dividend income from investment securities and interest bearing deposits at banks (tax equivalent basis)	\$ 1,662	\$ 1,927
Interest and fees on loans (non-tax adjusted)	\$ 11,861	\$ 9,717
Tax equivalent adjustment	178	321
Interest and fees on loans (tax equivalent basis)	\$ 12,039	\$ 10,038
Total interest income	\$ 13,383	\$ 11,300
Total interest expense	1,963	1,303
Net interest income	11,420	9,997
Total tax equivalent adjustment	318	665
Net interest income (tax equivalent basis)	\$ 11,738	\$ 10,662

The following table shows the tax-equivalent effect of changes in volume and rate on interest income and expense (in thousands):

	Three months ended March 31, 2018 vs. 2017 (1) Change in      Change    Total Volume in Rate    Change		
Interest Income:			
Short-term investments:			
Interest-bearing deposits at banks	\$-	\$ 3	\$ 3
Interest bearing time deposits at banks	17	3	20
Investment securities:			
Taxable	(79 )	137	58
Tax-exempt	(157 )	(189 )	(346 )
Total investments	(236 )	(52 )	(288 )
Loans:			
Residential mortgage loans	109	(19 )	90
Construction	(121 )	18	(103 )
Commercial Loans	925	(13 )	912
Agricultural Loans	1,225	(1 )	1,224
Loans to state & political subdivisions	88	(184 )	(96 )
Other loans	(19 )	(7 )	(26 )
Total loans, net of discount	2,207	(206 )	2,001
Total Interest Income	1,988	(252 )	1,736
Interest Expense:			
Interest-bearing deposits:			
NOW accounts	12	78	90
Savings accounts	2	3	5
Money Market accounts	38	77	115

Certificates of deposit	9	52	61
Total interest-bearing deposits	61	210	271
Other borrowed funds	313	76	389
Total interest expense	374	286	660
Net interest income	\$1,614	\$ (538 )	\$ 1,076

(1) The portion of the total change attributable to both volume and rate changes, which can not be separated, has been allocated proportionally to the change due to volume and the change due to rate prior to allocation.

Tax equivalent net interest income increased from \$10,662,000 for the three month period ended March 31, 2017 to \$11,738,000 for the three month period ended March 31, 2018, an increase of \$1,076,000. The tax equivalent net interest margin decreased from 3.78% for the first three months of 2017 to 3.68% for the comparable period in 2018 with a portion of the decrease attributable to the decrease in the statutory income tax rate from 34% in 2017 to 21% in 2018.

Total tax equivalent interest income for the 2018 three month period increased \$1,736,000 as compared to the 2017 three month period. This increase was primarily a result of an increase of \$1,988,000 due to a change in volume as average interest-bearing assets increased \$152.3 million. This increase was offset by a decrease of \$252,000 as a result of a decrease in the average yield on loans of 13 basis points from 4.92% to 4.79% for the comparable periods. As a result of converting investment assets to loans, the yield on average interest earning assets increased 4 basis points from 4.25% to 4.29%.



Tax equivalent investment income for the three months ended March 31, 2018 decreased \$288,000 over the same period last year. The primary cause of the decrease was a decrease in the average outstanding balance of investments. The average balance of taxable securities decreased by \$27.2 million, which resulted in a decrease in investment income of \$79,000. The decrease in the average balance of taxable securities was due to the Bank's strategy of funding loan growth through the cashflows of the investment portfolio. The yield on taxable securities increased 38 basis points from 1.67% to 2.05% as a result of the recent rise in rates and the calls and maturities of lower yielding investments. This resulted in an increase in investment income of \$137,000.

The average balance of tax-exempt securities decreased by \$15.5 million, which resulted in a decrease in investment income of \$157,000. The yield on tax-exempt securities decreased 112 basis points from 4.46% to 3.34%, which corresponds to a decrease in interest income of \$189,000. The yield decrease was partially attributable to the decrease in the federal statutory income tax rate as well as higher yielding securities being called and maturing and either being replaced by lower yielding securities or not replaced and utilized to fund loan growth. For a discussion of the Company's current investment strategy, see the "Financial Condition – Investments".

Total tax equivalent loan interest income increased \$2,001,000 for the three months ended March 31, 2018 compared to the same period last year, primarily as a result of loan growth achieved throughout 2017 and the first part of 2018 that was primarily due to the hiring of experienced lending teams in our central and south central Pennsylvania markets. It was also positively impacted by the acquisition of the State College branch in December of 2017.

The average balance of commercial loans increased \$72.1 million from a year ago. The growth was attributable to the State College branch acquisition and organic growth in our central and south central Pennsylvania markets. This had a positive impact of \$925,000 on total interest income due to volume. Offsetting this increase, there was a \$13,000 decrease due to rate, as the yield earned decreased from 5.22% to 5.20%.

Interest income on agricultural loans increased \$1,224,000 from 2017 to 2018. The increase in the average balance of agricultural loans of \$114.4 million is primarily attributable to the additional lenders hired in 2016 to serve the central and south central markets. The increase in the average balance of these loans resulted in an increase in interest income due to volume of \$1,225,000.

The average balance of construction loans decreased \$10.5 million from a year ago. This had a negative impact of \$121,000 and was due to transferring completed projects out of construction.

The average balance of state and political subdivision loans increased \$7.3 million from a year ago. This resulted in an increase of \$88,000 on total interest income due to volume. The yield decreased 67 basis points to 3.55%, which decreased loan interest income \$184,000. The decrease in the yield on this portfolio was mostly due to the decrease in the Federal statutory income tax rate from 2017 to 2018.

Interest income on residential mortgage loans increased \$90,000. The average balance of residential mortgage loans increased \$8.6 million, resulting in an increase of \$109,000 due to volume. The increase in volume was primarily due to the State College acquisition.

Total interest expense increased \$660,000 for the three months ended March 31, 2018 compared with the comparative period last year primarily as a result of an increase in borrowings to fund loan growth in 2017 and 2018 and higher rates paid on deposits and overnight borrowings. Interest expense increased \$374,000 as a result of volume as the average balance of interest bearing liabilities increased \$127.6 million. In addition, there was an increase of \$286,000 due to rate as a result of an increase in the average rate paid on interest bearing liabilities from 0.57% to 0.75%. A significant portion of the average deposit growth from 2017 to 2018 was the result of the State College branch acquisition and the remaining increase was due to deposit growth experienced in 2017.

## Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

The average balance of interest bearing deposits increased \$57.9 million from March 31, 2017 to March 31, 2018. Increases were experienced in NOW accounts of \$15.3 million, savings accounts of \$9.8 million, money market accounts of \$29.0 million and certificates of deposit of \$3.8 million. The cumulative effect of these volume changes was an increase in interest expense of \$61,000. see also "Financial Condition – Deposits"). The rate paid on interest bearing deposits increased 9 basis points to 0.58% for the first three months of 2018 compared to 2017. As a result of small variances in interest rates paid on individual products, interest expense on deposits increased \$210,000.

The average balance of other borrowed funds increased \$69.8 million from a year ago. This resulted in an increase in interest expense of \$313,000. There was an increase in the average rate on other borrowed fund from 1.52% to 1.89% due to an increase in the overnight borrowing rate as a result of the Federal Reserve interest rate moves in 2017 resulting in an increase in interest expense of \$76,000.

### Provision for Loan Losses

For the three month period ending March 31, 2018, we recorded a provision for loan losses of \$500,000, which represents a decrease of \$115,000 from the \$615,000 provision recorded in the corresponding three months of last year. The provision was lower in 2018 than 2017 primarily due to the lower organic loan growth that occurred in the first three months of 2018 compared to 2017 (see "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

### Non-interest Income

The following table shows the breakdown of non-interest income for the three months ended March 31, 2018 and 2017 (dollars in thousands):

	Three months ended March		Change	
	31, 2018	2017	Amount	%
Service charges	\$1,104	\$1,058	\$46	4.3
Trust	251	221	30	13.6
Brokerage and insurance	181	191	(10 )	(5.2 )
Gains on loans sold	72	101	(29 )	(28.7 )
Equity security gains, net	6	-	6	NA
Available for sale security gains, net	-	172	(172)	(100.0)
Earnings on bank owned life insurance	152	166	(14 )	(8.4 )
Other	140	126	14	11.1
Total	\$1,906	\$2,035	\$(129)	(6.3 )

Non-interest income for the three months ended March 31, 2018 totaled \$1,906,000, a decrease of \$129,000 when compared to the same period in 2017. During the first three months of 2018, net investment securities gains amounted to \$6,000 compared to gains of \$172,000 last year. We recognized a \$6,000 increase in the market value of our equity portfolio in 2018. We did not sell any available for sale securities in 2018. In 2017, we sold five agency securities for gains totaling \$10,000 and two of our equity positions for a gain of \$160,000.

For the first three months of 2018, account service charges totaled \$1,104,000, an increase of \$46,000 or 4.3%, when compared to the same period in 2017. The increase was associated with a \$32,000 increase in interexchange revenue and a \$19,000 increase in ATM income. The decrease in gains on loans sold is due to a decrease in the amount of loans sold in 2018 compared to 2017. Trust revenues have increased as the result of estate settlement fees increasing.

### Non-interest Expense

The following tables reflect the breakdown of non-interest expense for the three months ended March 31, 2018 and 2017 (dollars in thousands):

39

---

	Three months ended		Change	
	March 31, 2018	2017	Amount	%
Salaries and employee benefits	\$4,835	\$4,366	\$ 469	10.7
Occupancy	592	527	65	12.3
Furniture and equipment	142	139	3	2.2
Professional fees	295	310	(15 )	(4.8 )
FDIC insurance	100	105	(5 )	(4.8 )
Pennsylvania shares tax	300	281	19	6.8
Amortization of intangibles	76	76	-	-
ORE expenses	138	90	48	53.3
Other	1,354	1,297	57	4.4
Total	\$7,832	\$7,191	\$ 641	8.9

Non-interest expenses increased \$641,000 for the three months ended March 31, 2018 compared to the same period in 2017. Salaries and employee benefits increased \$469,000 or 10.7%. The increase was due to merit increases effective at the beginning of 2018, an increase in the number of full-time equivalent employees of 7.0 as a result additional branch locations, specifically State College, and an increase in profit sharing and retirement expenses as a result of additional headcount and financial results.

The primary cause of the increases in occupancy expenses are due to the acquisition of the State College branch and the openings of the limited branch office in Narvon, Pennsylvania. The increase in ORE expenses is the result of legal fees associated with a customer that is in bankruptcy.

#### Provision for Income Taxes

The provision for income taxes was \$747,000 for the three months ended March 31, 2018 compared to \$923,000 for the same period in 2017. The decrease is attributable to the decrease in the Federal statutory income tax rate from 34% in 2017 to 21% in 2018. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 15.0% and 21.8% for the first three months of 2018 and 2017, respectively, compared to the statutory rate of 21% for 2018 and 34% for 2017.

We are invested in four limited partnership agreements that have established low-income housing projects in our market areas. We anticipate recognizing an aggregate of \$670,000 of tax credits over the next 4.75 years, with an additional \$106,000 anticipated to be recognized during 2018.

#### Financial Condition

Total assets were \$1.38 billion at March 31, 2018, an increase of \$20.6 million from \$1.36 billion at December 31, 2017. Cash and cash equivalents decreased \$6.0 million to \$12.5 million. Investment securities decreased \$3.4 million and net loans increased \$30.8 million to \$1.02 billion at March 31, 2018. Total deposits increased \$10.2 million to \$1.12 billion since year-end 2017, while borrowed funds increased \$9.5 million to \$124.1 million.

#### Cash and Cash Equivalents

Cash and cash equivalents totaled \$12.5 million at March 31, 2018 compared to \$18.5 million at December 31, 2017, a decrease of \$6.0 million. Management actively measures and evaluates its liquidity position through our Asset-Liability Committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources including the Bank's core deposits, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will

permit us to meet cash obligations and off-balance sheet commitments as they come due.

40

---

## Investments

The following table shows the composition of the investment portfolio (including debt and equity securities) as of March 31, 2018 and December 31, 2017 (dollars in thousands):

	March 31, 2018		December 31, 2017	
	Amount	%	Amount	%
Debt securities:				
U. S. Agency securities	\$99,186	39.4	\$98,887	38.8
U. S. Treasury notes	33,112	13.2	28,604	11.2
Obligations of state & political subdivisions	71,532	28.4	79,090	31.0
Corporate obligations	3,050	1.2	3,083	1.2
Mortgage-backed securities in government sponsored entities	44,460	17.7	45,027	17.7
Equity securities (a)	188	0.1	91	0.1
Total	\$251,528	100.0	\$254,782	100.0

	March 31, 2018/ December 31, 2017	
	Change Amount	%
Debt securities:		
U. S. Agency securities	\$299	0.3
U. S. Treasury notes	4,508	15.8
Obligations of state & political subdivisions	(7,558)	(9.6 )
Corporate obligations	(33 )	(1.1 )
Mortgage-backed securities in government sponsored entities	(567 )	(1.3 )
Equity securities	97	106.6
Total	\$(3,254)	(1.3 )

a. As of January 1, 2018, the Company adopted ASU 2016-01 resulting in the reclassification of equity securities from available for sale securities to equity securities in the Consolidated Balance Sheet.

Our investment portfolio decreased by \$3.3 million, or 1.3%, from December 31, 2017 to March 31, 2018. During 2018, we purchased approximately \$5.0 million of treasury securities, \$14.8 million of U.S. agency obligations, \$2.1 million of mortgage-backed securities in government sponsored entities and \$91,000 of equity securities, which helped offset the \$2.1 million of principal repayments and \$20.8 million of calls and maturities that occurred during the three month period. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio for the three month period ended March 31, 2018 yielded 2.48%, compared to 2.51% in the comparable period in 2017 on a tax equivalent basis.

The investment strategy for 2018 has been to utilize cashflows from the investment portfolio to purchase agency and treasury securities to pledge against our public deposits. Investment purchases have been focused on securities with short fixed maturities for agency and treasury securities. We continually monitor interest rate trading ranges and try to focus purchases to times when rates are in the top third of the trading range. The Bank believes its investment strategy has appropriately mitigated its interest rate risk exposure if rates continue to rise, while providing sufficient cashflows to meet liquidity needs.

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

#### Loans

The following table shows the composition of the loan portfolio as of March 31, 2018 and December 31, 2017 (dollars in thousands):

41

---

	March 31, 2018		December 31, 2017	
	Amount	%	Amount	%
Real estate:				
Residential	\$215,349	20.9	\$214,479	21.4
Commercial	320,381	31.1	308,084	30.8
Agricultural	248,710	24.1	239,957	24.0
Construction	22,239	2.2	13,502	1.3
Consumer	9,672	0.9	9,944	1.0
Other commercial loans	74,930	7.3	72,013	7.2
Other agricultural loans	40,396	3.9	37,809	3.8
State & political subdivision loans	100,061	9.6	104,737	10.5
Total loans	1,031,738	100.0	1,000,525	100.0
Less allowance for loan losses	11,587		11,190	
Net loans	\$1,020,151		\$989,335	

	March 31, 2018/ December 31, 2017 Change	
	Amount	%
Real estate:		
Residential	\$870	0.4
Commercial	12,297	4.0
Agricultural	8,753	3.6
Construction	8,737	64.7
Consumer	(272)	(2.7)
Other commercial loans	2,917	4.1
Other agricultural loans	2,587	6.8
State & political subdivision loans	(4,676)	(4.5)
Total loans	\$31,213	3.1

The Bank's lending efforts have historically focused on north central Pennsylvania and southern New York. The acquisition of FNB in 2015 expanded the focus to Lebanon, Lancaster, Schuylkill and Berks County markets in south central Pennsylvania. The acquisition of the State College branch in 2017 and the opening of the Winfield office in 2016 has increased our presence in the central Pennsylvania market. We originate loans primarily through direct loans to our existing customer base, with new customers generated through the strong relationships our new lending teams have with their customers, as well as by referrals from real estate brokers, building contractors, attorneys, accountants, corporate and advisory board members, existing customers and the Bank's website. The Bank offers a variety of loans although historically most of our lending has focused on real estate loans including residential, commercial, agricultural, and construction loans. All lending is governed by a lending policy that is developed and administered by management and approved by the Board of Directors. As of March 31, 2018, the Company had one industry specific loan concentration, within the dairy industry, totaling \$138.4 million or 13.4% of total loans.

During the first three months of 2018, the primary driver of growth in the loan portfolio continued to be commercial and agricultural real estate loans in both the central and south central Pennsylvania markets. Commercial and agricultural loan demand is subject to significant competitive pressures, the yield curve, and the strengthening of the overall national, regional and local economies.

While the Bank has lent to companies that service the exploration for natural gas in our market area, the Bank has not originated any loans to companies performing the actual drilling and exploration activities. Loans made by the Company are to service industry customers which include trucking companies, stone quarries and other support businesses. We also have originated loans to businesses and individuals for restaurants, hotels and apartment rentals



that have been developed and expanded to meet the housing and living needs of the gas workers. Due to our understanding of the industry and its cyclical nature, the loans made for natural gas-related activities have been originated in accordance with specific policies and procedures for lending to these entities, which include more stringent loan to value thresholds, shortened amortization periods, and expansion of our monitoring of loan concentrations associated with this activity.

42

---

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Residential real estate loans increased slightly during the first three months of 2018. Loan demand for conforming mortgages, which the Company typically sells on the secondary market has decreased in 2018 when compared to 2017. For loans sold on the secondary market, the Company recognizes fee income for servicing these sold loans, which is included in non-interest income.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level which in management's judgment is adequate to absorb probable future loan losses inherent in the loan portfolio. The provision for loan losses is charged against current income. Loans deemed not collectable are charged-off against the allowance while subsequent recoveries increase the allowance. The following table presents an analysis of the allowance for loan losses and non-performing loans and assets as of and for the three months ended March 31, 2018 and for the years ended December 31, 2017, 2016, 2015 and 2014 (dollars in thousands):

	March 31, 2018	December 31, 2017	2016	2015	2014
Balance at beginning of period	\$11,190	\$8,886	\$7,106	\$6,815	\$7,098
Charge-offs:					
Real estate:					
Residential	15	107	85	66	97
Commercial	-	41	100	84	516
Agricultural	-	30	-	-	-
Consumer	13	130	100	47	47
Other commercial loans	45	-	55	41	250
Other agricultural loans	43	5	-	-	-
Total loans charged-off	116	313	340	238	910
Recoveries:					
Real estate:					
Residential	-	-	-	-	-
Commercial	-	11	479	14	15
Agricultural	-	-	-	-	-
Consumer	10	49	88	33	27
Other commercial loans	3	16	33	2	-
Other agricultural loans	-	1	-	-	-
Total loans recovered	13	77	600	49	42
Net loans (recovered) charged-off	103	236	(260 )	189	868
Provision charged to expense	500	2,540	1,520	480	585
Balance at end of period	\$11,587	\$11,190	\$8,886	\$7,106	\$6,815
Loans outstanding at end of period	\$1,031,738	\$1,000,525	\$799,611	\$695,031	\$554,105
Average loans outstanding, net	\$1,018,195	\$883,355	\$725,881	\$577,992	\$540,541
Non-performing assets:					
Non-accruing loans	\$11,433	\$10,171	\$11,454	\$6,531	\$6,599
Accrual loans - 90 days or more past due	429	555	405	623	836
Total non-performing loans	\$11,862	\$10,726	\$11,859	\$7,154	\$7,435
Foreclosed assets held for sale	952	1,119	1,036	1,354	1,792
Total non-performing assets	\$12,814	\$11,845	\$12,895	\$8,508	\$9,227
Annualized net charge-offs to average loans	0.04	% 0.03	% -0.04	% 0.03	% 0.16
Allowance to total loans	1.12	% 1.12	% 1.11	% 1.02	% 1.23
Allowance to total non-performing loans	97.68	% 104.33	% 74.93	% 99.33	% 91.66

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Non-performing loans as a percent of loans net of unearned income	1.15	%	1.07	%	1.48	%	1.03	%	1.34	%
Non-performing assets as a percent of loans net of unearned income	1.24	%	1.18	%	1.61	%	1.22	%	1.67	%

43

---

Management believes it uses the best information available when estimating the allowance for loan losses and that the allowance for loan losses is adequate as of March 31, 2018. However, future adjustments could be required if circumstances differ substantially from assumptions and estimates used in making the initial determination. A prolonged downturn in the economy, high unemployment rates, significant changes in the value of collateral and delays in receiving financial information from borrowers could result in increased levels of non-performing assets, charge-offs, loan loss provisions and reduction in income. Additionally, bank regulatory agencies periodically examine the Bank's allowance for loan losses. The banking agencies could require the recognition of additions to the allowance for loan losses based upon their judgment of information available to them at the time of their examination.

On a monthly basis, problem loans are identified and updated primarily using internally prepared past due reports. Based on data surrounding the collection process of each identified loan, the loan may be added or deleted from the monthly watch list. The watch list includes loans graded special mention, substandard, doubtful, and loss, as well as additional loans that management may choose to include. Watch list loans are continually monitored going forward until satisfactory conditions exist that allow management to upgrade and remove the loan. In certain cases, loans may be placed on non-accrual status or charged-off based upon management's evaluation of the borrower's ability to pay. All commercial loans, which include commercial real estate, agricultural real estate, state and political subdivision loans and other commercial and agricultural loans, on non-accrual are evaluated quarterly for impairment.

The allowance for loan losses was \$11,587,000 or 1.12% of total loans as of March 31, 2018 as compared to \$11,190,000 or 1.12% of loans as of December 31, 2017. The \$397,000 increase in the allowance during the first three months of 2018 is the result of a \$500,000 provision and net charge-offs of \$103,000. The following table shows the distribution of the allowance for loan losses and the percentage of loans compared to total loans by loan category as of March 31, 2018 and December 31, 2017, 2016, 2015 and 2014 (dollars in thousands):

	March 31, 2018		December 31 2017		2016		2015		2014	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Residential	\$1,077	20.9	\$1,049	21.4	\$1,064	25.9	\$905	29.3	\$878	33.5
Commercial	4,006	31.1	3,867	30.8	3,589	31.6	3,376	34.2	3,419	34.5
Agricultural	3,340	24.1	3,143	24.0	1,494	15.5	409	8.3	451	4.4
Construction	39	2.2	23	1.3	47	3.2	24	2.2	26	1.1
Consumer	123	0.9	124	1.0	122	1.4	102	1.7	84	1.5
Other commercial loans	1,273	7.3	1,272	7.2	1,327	7.3	1,183	8.2	1,007	8.6
Other agricultural loans	532	3.9	492	3.8	312	2.9	122	2.0	217	2.0
State & political subdivision loans	789	9.6	816	10.5	833	12.2	593	14.1	545	14.4
Unallocated	408	N/A	404	N/A	98	N/A	392	N/A	188	N/A
Total allowance for loan losses	\$11,587	100.0	\$11,190	100.0	\$8,886	100.0	\$7,106	100.0	\$6,815	100.0

As a result of previous loss experiences and other risk factors utilized in determining the allowance, the Bank's allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 55.2% of the loan portfolio, 63.4% of the allowance is assigned to this segment of the loan portfolio as these loans have more inherent risks than residential real estate or loans to state and political subdivisions.

The following table identifies amounts of loans contractually past due 30 to 89 days and non-performing loans by loan category, as well as the change from December 31, 2017 to March 31, 2018 in non-performing loans (dollars in thousands). Non-performing loans include accruing loans that are contractually past due 90 days or more and non-accrual loans. 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.

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

	March 31, 2018				December 31, 2017			
	Non-Performing Loans				Non-Performing Loans			
	30 - 89 Days				30 - 89 Days			
	90 Days				90 Days			
	Past Due	Past Due	Non-accrual	Total Non-Performing	Past Due	Past Due	Non-accrual	Total Non-Performing
(in thousands)	Accruing	Accruing	accrual	Performing	Accruing	Accruing	accrual	Performing
Real estate:								
Residential	\$755	\$44	\$1,556	\$ 1,600	\$1,550	\$218	\$1,386	\$ 1,604
Commercial	4,198	-	6,372	6,372	1,519	162	5,192	5,354
Agricultural	85	-	194	194	242	30	175	205
Construction	-	-	127	127	-	-	133	133
Consumer	137	7	30	37	86	7	42	49
Other commercial loans	485	378	2,494	2,872	50	32	2,637	2,669
Other agricultural loans	-	-	660	660	42	106	606	712
Total nonperforming loans	\$5,660	\$429	\$11,433	\$ 11,862	\$3,489	\$555	\$10,171	\$ 10,726

	Change in Non-Performing Loans	
	March 31, 2018 /December 31, 2017	
(in thousands)	Amount	%
Real estate:		
Residential	\$(4 )	(0.2 )
Commercial	1,018	19.0
Agricultural	(11 )	(5.4 )
Construction	(6 )	N/A
Consumer	(12 )	(24.5)
Other commercial loans	203	7.6
Other agricultural loans	(52 )	(7.3 )
Total nonperforming loans	\$1,136	10.6

For the three months ended March 31, 2018, we recorded a provision for loan losses of \$500,000, which compares to \$615,000 for the same period in 2017. The decrease was primarily attributable to the loan growth experienced during 2018 being lower than the growth experienced during the comparable period of 2017. Non-performing loans increased \$1.1 million or 10.6%, from December 31, 2017 to March 31, 2018, primarily due to two customers. Approximately 50.5% of the Bank's non-performing loans at March 31, 2018 are associated with the following two customer relationships:

- A commercial customer with a total loan relationship of \$3.0 million, secured by undeveloped land, stone quarries and equipment, was on non-accrual status as of March 31, 2018. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer, who provides excavation services and stone for pad construction related to these activities. During 2017, the Company had the underlying collateral appraised. The appraisals indicated a decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. Management determined that no specific

reserve was required as of March 31, 2018.

A commercial customer with a total loan relationship of \$2.6 million, secured by residential rental properties, was on non-accrual status as of March 31, 2018. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. In July of 2013, the customer filed for bankruptcy under Chapter 11 and a Trustee was appointed in January of 2014. In 2015, the Trustee decreased the loan payments below what was agreed to in the forbearance agreement. This decrease is currently being litigated in bankruptcy court. As a result of the decrease, the relationship has become more than 90 days past due. During 2016, the Company appraised the underlying collateral. The appraisals indicated a slight decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. We continue to monitor the bankruptcy proceedings to identify potential changes in the customer's operations and the impact these would have on the loan payments for our loans to the customer and the underlying collateral that supports these loans. As of March 31, 2018, there was no specific reserve for this relationship.

Management of the Bank believes that the allowance for loan losses as of March 31, 2018 is adequate, which is based on the following factors:

Two loan relationships comprise 50.5% of the non-performing loan balance, whose debt is considered well collateralized and has no specific reserves as of March 31, 2018.

As seen on page 43, the Company has a history of low charge-offs, which continued in 2018 as the net charge-offs were .04% of average loans and only \$103,000. In 2016, a net recovery was experienced as the result of recovering a loan that was partially charged off in 2014.

#### Bank Owned Life Insurance

The Company holds bank owned life insurance policies to offset future employee benefit costs. These policies provide the Bank with an asset that generates 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. As of March 31, 2018 and December 31, 2017, the cash surrender value of the life insurance was \$27.0 million and \$26.9 million, respectively. The change in cash surrender value, net of purchases and amounts acquired through acquisitions, is recognized in the results of operations. The amounts recorded as non-interest income totaled \$152,000 and \$166,000 for the three month periods ended March 31, 2018 and 2017, respectively. The Company evaluates annually the risks associated with the life insurance policies, including limits on the amount of coverage and an evaluation of the various carriers' credit ratings.

The Company agreements that were purchased directly from insurance companies are structured so that any death benefits received from a policy while the insured person is an active employee of the Bank will be split with the beneficiary of the policy. Under these agreements, the employee's beneficiary will be entitled to receive 50% of the net amount at risk from the proceeds. The net amount at risk is the total death benefit payable less the cash surrender value of the policy as of the date of death. The policies acquired as part of the acquisition of FNB provide a fixed split-dollar benefit for the beneficiaries estate, which is dependent on several factors including whether the covered individual was a Director of FNB or an employee of FNB and their salary level. As of March 31, 2018 and December 31, 2017, included in other liabilities on the Consolidated Balance Sheet was a liability of \$598,000 and \$578,000, respectively, for the obligation under the split-dollar benefit agreements.

#### Premises and Equipment

Premises and equipment decreased \$145,000 to \$16.4 million as of March 31, 2018 from December 31, 2017. This occurred primarily as a result of normal depreciation expense recorded in the first three months of 2018.

#### Deposits

The following table shows the composition of deposits as of March 31, 2018 and December 31, 2017 (dollars in thousands):

	March 31, 2018		December 31, 2017	
	Amount	%	Amount	%
Non-interest-bearing deposits	\$173,124	15.5	\$171,840	15.6
NOW accounts	324,745	29.1	337,307	30.5
Savings deposits	189,429	17.0	184,057	16.7
Money market deposit accounts	160,439	14.4	145,287	13.1
Certificates of deposit	267,416	24.0	266,452	24.1
Total	\$1,115,153	100.0	\$1,104,943	100.0





	March 31, 2018/ December 31, 2017	Change
	Amount	%
Non-interest-bearing deposits	\$1,284	0.7
NOW accounts	(12,562)	(3.7)
Savings deposits	5,372	2.9
Money market deposit accounts	15,152	10.4
Certificates of deposit	964	0.4
Total	\$10,210	0.9

Deposits increased \$10.2 million since December 31, 2017. Customers, including local municipalities transferred balances from NOW accounts to money market accounts, which accounts for the majority of the changes in those accounts. As a result of strategic initiatives, we have grown our deposits through improving our cash management services.

Certificates of deposits increased \$964,000 in 2018. The rates paid on certificates of deposits have increased in the first part of 2018 making them more attractive to customers who typically utilize certificate of deposits as a means of generating income or as a longer term investment option. The rates paid on certificates of deposit by the Company remain competitive with rates paid by our competition. As of March 31, 2018, the Bank did not have any outstanding brokered certificates of deposit.

#### Borrowed Funds

Borrowed funds increased \$9.5 million during the first three months of 2018. The increase was the result of borrowing an additional \$9.8 million of overnight advances from the FHLB as a result of the loan growth experienced in the first quarter of 2018. Offsetting this, there was a decrease of approximately \$300,000 in the balances outstanding under repurchase agreements. The Bank's current strategy for borrowings is to consider terms and structures to manage interest rate risk and liquidity in a potential rising interest rate environment. The Company's daily cash requirements or short-term investments are primarily met by using the financial instruments available through the Federal Home Loan Bank of Pittsburgh.

#### Stockholders' 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 will meet its cash obligations and absorb unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance. As such, the Company has implemented policies and procedures to ensure that it has adequate capital levels. As part of this process, we routinely stress test our capital levels and identify potential risk and alternative sources of additional capital should the need arise.

Total stockholders' equity was \$129.9 million at March 31, 2018 compared to \$129.0 million at December 31, 2017, an increase of \$839,000, or 0.7%. Excluding accumulated other comprehensive income, stockholders' equity increased \$2.4 million, or 1.8%. The Company purchased 5,329 shares of treasury stock at a weighted average cost of \$62.08 per share. The Company reissued 217 shares to certain employees as a reward for years of services at a weighted average cost of \$62.47 per share. In the first three months of 2018, the Company had net income of \$4.2 million and declared cash dividends of \$1.5 million, or \$0.435 per share, representing a cash dividend payout ratio of 35.7%.

All of the Company's debt 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. As a result of changes in the interest rate environment and the defined benefit plan obligations, accumulated other comprehensive income decreased approximately \$1.6 million from December 31, 2017.

The Company and Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory-and possibly additional discretionary-actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Bank must meet specific capital guidelines that involve quantitative measures of the Company and Bank's assets, liabilities, and certain off-balance-sheet items as calculated under U.S. GAAP, regulatory reporting requirements, and regulatory capital standards. The Company and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Edgar Filing: CITIZENS FINANCIAL SERVICES INC - Form 10-Q

Quantitative measures established by regulatory capital standards to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios of total and Tier 1 capital (as defined) to risk-weighted assets (as defined), common equity Tier 1 capital (as defined) to total risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of March 31, 2018 and December 31, 2017, that the Company and Bank meet all capital adequacy requirements to which they are subject.

As of March 31, 2018 and December 31, 2017, the Company and Bank are categorized as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company must maintain minimum total risk-based capital, Tier 1 risk-based capital, common equity Tier 1 risk-based capital, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company and Bank's computed risk based capital ratios are as follows (dollars in thousands):

March 31, 2018	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighted Assets):						
Company	\$131,274	13.09 %	\$80,204	8.00 %	\$100,255	10.00 %
Bank	\$125,013	12.48 %	\$80,168	8.00 %	\$100,210	10.00 %

Tier 1 Capital (to Risk Weighted Assets):						
Company	\$119,522	11.92 %	\$60,153	6.00 %	\$80,204	8.00 %
Bank	\$113,260	11.30 %	\$60,126	6.00 %	\$80,168	8.00 %

Common Equity Tier 1 Capital (to Risk Weighted Assets):						
Company	\$112,022	11.17 %	\$45,115	4.50 %	\$65,166	6.50 %
Bank	\$113,260	11.30 %	\$45,095	4.50 %	\$65,137	6.50 %

Tier 1 Capital (to Average Assets):						
Company	\$119,522	8.87 %	\$53,887	4.00 %	\$67,358	5.00 %
Bank	\$113,260	8.41 %	\$53,859	4.00 %	\$67,324	5.00 %

December 31, 2017	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighted Assets):						
Company	\$128,578	13.20 %	\$77,906	8.00 %	\$97,383	10.00 %
Bank	\$122,469	12.58 %	\$77,852	8.00 %	\$97,315	10.00 %

Tier 1 Capital (to Risk Weighted Assets):						
Company	\$117,224	12.04 %	\$58,430	6.00 %	\$77,906	8.00 %
Bank	\$111,114	11.42 %	\$58,389	6.00 %	\$77,852	8.00 %

Common Equity Tier 1 Capital (to Risk Weighted Assets):

Company	\$109,724	11.27%	\$43,822	4.50%	\$63,299	6.50%
Bank	\$111,114	11.42%	\$43,792	4.50%	\$63,255	6.50%

Tier 1 Capital (to Average Assets):

Company	\$117,224	9.18%	\$51,085	4.00%	\$63,857	5.00%
Bank	\$111,114	8.71%	\$51,023	4.00%	\$63,778	5.00%

## 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 March 31, 2018 and December 31, 2017 (in thousands):

	March 31, 2018	December 31, 2017
Commitments to extend credit	\$187,702	\$188,482
Standby letters of credit	15,593	15,244
	\$203,295	\$203,726

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing. Overdraft charges as a result of ATM withdrawals and one time point of sale (non-recurring) transactions require prior approval of the customer. The non-contractual amount of financial instruments with off-balance sheet risk at March 31, 2018 and December 31, 2017 was \$9,372,000 and \$9,335,000, respectively. The Company reserves the right to discontinue this service without prior notice.

## Liquidity

Liquidity is a measure of the Company's ability to efficiently meet normal cash flow requirements of both borrowers and depositors. To maintain proper liquidity, we use funds management policies, which include liquidity target ratios, 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.

Cash generated by operating activities, investing activities and financing activities influences liquidity management. Our Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows. The most important source of funds is core deposits. Repayment of principal on outstanding loans and cash flows created from the investment portfolio are also factors in liquidity management. Other sources of funding include brokered certificates of deposit and the sale of loans or investments, if needed.

The 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 uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures (including software purchases), during the first three months of 2018 were \$41,000 compared to \$113,000 during the same time period in 2017.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$472.1 million, of which \$101.9 million was outstanding at March 31, 2018. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon. We also have a borrower in custody line with the Federal Reserve Bank of approximately \$4.2 million, which also is not drawn upon as of March 31, 2018. The Company continues to evaluate its liquidity needs and as necessary finds additional sources.

Citizens Financial Services, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial Services, Inc. is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial Services, Inc.'s primary source of income is dividends received from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. In particular, the Bank may not, as a state-chartered bank which is a member of the Federal Reserve System, declare a dividend without approval of the Federal Reserve, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At March 31, 2018, Citizens Financial Services, Inc. (on an unconsolidated basis) had liquid assets of \$6.1 million.

### 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 and, because we have no trading portfolio, we are not subject to trading risk. Currently, the Company has equity securities that represent only 0.01% of its total assets 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 sensitive (except for the top-tier money market investor accounts, typically held by local governments, 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.

The 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 and asset liability management processes that we believe will effectively identify, measure, and monitor the Company's risk exposure. In this analysis, the Company examines the results of movements in interest rates with additional assumptions made concerning prepayment speeds on mortgage loans and mortgage securities. Shock scenarios, which assume a parallel shift in interest rates and is instantaneous, typically have the greatest impact on net interest income. The following is a rate shock analysis and the impact on net interest income as of March 31, 2018 (dollars in thousands):

		% Change	
	Change In	In	
Prospective			
One-Year	Prospective	Prospective	
Changes in Rates			

	Net Interest Income	Net Interest Income	Net Interest Income
-100 Shock	\$ 45,634	\$ (812 )	(1.8 )
Base	46,446	-	-
+100 Shock	45,181	(1,265 )	(2.7 )
+200 Shock	43,699	(2,747 )	(5.9 )
+300 Shock	42,238	(4,208 )	(9.1 )
+400 Shock	40,750	(5,696 )	(12.3 )



The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage backed securities, call activity of other investment securities, and deposit selection, re-pricing and maturity structure. Because of these assumptions, actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change on net interest income. Additionally, the changes above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. It should be noted that the changes in net interest income noted above are in line with Company policy for interest rate risk.

#### 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 (see also "Interest Rate and Market Risk Management").

#### Item 4-Control and Procedures

##### (a) Disclosure Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the SEC (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

##### (b) Changes to Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the quarter ended March 31, 2018 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

#### Item 1 Legal Proceedings

Management is not aware of any pending or threatened 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

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1.A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, which could materially affect our business, financial condition or future results. At March 31, 2018, the risk factors of the Company have not changed materially from those reported in our Annual Report on Form 10-K. However, the risks

described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares (or units Purchased)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1)
1/1/18 to 1/31/18	-	\$ 0.00	-	89,439
2/1/18 to 2/28/18	3,969	\$ 62.01	3,936	85,503
3/1/18 to 3/31/18	1,360	\$ 62.29	1,360	84,143
Total	5,329	\$ 62.08	5,296	84,143

On October 20, 2015, the Company announced that the Board of Directors authorized the Company to repurchase up to an additional 150,000 shares. The repurchases will be conducted through open-market purchases or privately (1) negotiated transactions and will be made from time to time depending on market conditions and other factors. No time limit was placed on the duration of the share repurchase program. Any repurchased shares will be held as treasury stock and will be available for general corporate purposes.

Item 3 Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosure

Not applicable.

Item 5 Other Information

None

Item 6 Exhibits

(a) The following documents are filed as a part of this report:

- 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>
- 4.1 Form of Common Stock Certificate.<sup>(3)</sup>

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 and Chief Financial Officer

The following materials from the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) The Consolidated Balance Sheet (unaudited), (ii) the Consolidated Statement of Income (unaudited), (iii) the Consolidated Statement of Comprehensive Income (unaudited), (iv) the Consolidated Statement of Cash Flows (unaudited) and (v) related notes (unaudited).

101  
\*\*

---

<sup>(1)</sup> Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2010, as filed with the Commission on May 12, 2010.

52

---

(2) Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K, as filed with the Commission on December 24, 2009.

(3) Incorporated by reference to Exhibit 4 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the Commission on March 14, 2006.

\*\* Furnished, not filed.

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)

May 10, 2018 By: /s/ Randall E. Black  
Randall E. Black  
President and Chief Executive Officer  
(Principal Executive Officer)

May 10, 2018 By: /s/ Mickey L. Jones  
Mickey L. Jones  
Chief Financial Officer  
(Principal Financial and Accounting Officer)