

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
August 07, 2008

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 June 30, 2008

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 23-2265045  
(State or other jurisdiction of incorporation or organization) (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

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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. (See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.)

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of shares outstanding, as of August 4, 2008, was 2,848,714 shares of the Registrant's Common Stock, par value \$1.00.

---

Citizens Financial Services, Inc.  
Form 10-Q

INDEX

	PAGE	
Part I	FINANCIAL INFORMATION	
Item 1.	Financial Statements (unaudited):	
	Consolidated Balance Sheet as of June 30, 2008 and December 31, 2007	1
	Consolidated Statement of Income for the Three Months and Six Months Ended June 30, 2008 and 2007	2
	Consolidated Statement of Comprehensive Income for the Three Months and Six Months Ended June 30, 2008 and 2007	3
	Consolidated Statement of Cash Flows for the Six Months Ended June 30, 2008 and 2007	4
	Notes to Consolidated Financial Statements	5-8
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	9-24
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	25
Item 4.	Controls and Procedures	25
Part II	OTHER INFORMATION	
Item 1.	Legal Proceedings	26
Item 1A.	Risk Factors	26
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	26
Item 3.	Defaults upon Senior Securities	26
Item 4.	Submission of Matters to a Vote of Security Holders	27
Item 5.	Other Information	27
Item 6.	Exhibits	28
	Signatures	29

---

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

(in thousands except share data)	June 30, 2008	December 31, 2007
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$ 12,931	\$ 10,374
Interest-bearing	1	15
Total cash and cash equivalents	12,932	10,389
Available-for-sale securities	124,674	120,802
Loans (net of allowance for loan losses: 2008, \$4,287 and 2007, \$4,197)	424,144	419,182
Premises and equipment	12,289	12,538
Accrued interest receivable	2,563	2,522
Goodwill	8,605	8,605
Bank owned life insurance	8,549	8,378
Other assets	8,258	8,613
<b>TOTAL ASSETS</b>	<b>\$ 602,014</b>	<b>\$ 591,029</b>
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$ 56,968	\$ 50,944
Interest-bearing	428,161	405,084
Total deposits	485,129	456,028
Borrowed funds	60,067	80,348
Accrued interest payable	1,951	2,199
Other liabilities	4,296	3,926
<b>TOTAL LIABILITIES</b>	<b>551,443</b>	<b>542,501</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock		
\$1.00 par value; authorized 10,000,000 shares;		
issued 3,020,538 shares at June 30, 2008 and December 31,		
2007, respectively		
	3,020	3,020
Additional paid-in capital	12,357	12,439
Retained earnings	40,743	37,590
Accumulated other comprehensive loss	(1,319)	(348)
Treasury stock, at cost: 196,927 shares for 2008 and 194,883 shares for 2007	(4,230)	(4,173)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>50,571</b>	<b>48,528</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 602,014</b>	<b>\$ 591,029</b>

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



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

(in thousands, except per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 7,645	\$ 7,539	\$ 15,309	\$ 14,896
Investment securities:				
Taxable	1,132	1,057	2,255	2,071
Nontaxable	353	225	689	449
Dividends	56	78	141	169
<b>TOTAL INTEREST INCOME</b>	<b>9,186</b>	<b>8,899</b>	<b>18,394</b>	<b>17,585</b>
<b>INTEREST EXPENSE:</b>				
Deposits	2,728	3,430	5,671	6,740
Borrowed funds	628	806	1,485	1,732
<b>TOTAL INTEREST EXPENSE</b>	<b>3,356</b>	<b>4,236</b>	<b>7,156</b>	<b>8,472</b>
<b>NET INTEREST INCOME</b>	<b>5,830</b>	<b>4,663</b>	<b>11,238</b>	<b>9,113</b>
Provision for loan losses	-	45	120	165
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>5,830</b>	<b>4,618</b>	<b>11,118</b>	<b>8,948</b>
<b>NON-INTEREST INCOME:</b>				
Service charges	871	812	1,647	1,560
Trust	136	127	303	264
Brokerage and insurance	74	31	118	49
Gain on sales of foreclosed properties	-	373	-	396
Earnings on bank owned life insurance	86	82	171	162
Other	151	166	288	287
<b>TOTAL NON-INTEREST INCOME</b>	<b>1,318</b>	<b>1,591</b>	<b>2,527</b>	<b>2,718</b>
<b>NON-INTEREST EXPENSES:</b>				
Salaries and employee benefits	2,158	2,033	4,314	4,126
Occupancy	281	308	595	609
Furniture and equipment	128	140	261	268
Professional fees	148	155	329	320
Other	1,223	1,320	2,354	2,410
<b>TOTAL NON-INTEREST EXPENSES</b>	<b>3,938</b>	<b>3,956</b>	<b>7,853</b>	<b>7,733</b>
Income before provision for income taxes	3,210	2,253	5,792	3,933
Provision for income taxes	764	493	1,325	793
<b>NET INCOME</b>	<b>\$ 2,446</b>	<b>\$ 1,760</b>	<b>\$ 4,467</b>	<b>\$ 3,140</b>
<b>Earnings Per Share</b>				
Earnings Per Share	\$ 0.87	\$ 0.62	\$ 1.58	\$ 1.10
<b>Cash Dividends Paid Per Share</b>				
Cash Dividends Paid Per Share	\$ 0.235	\$ 0.225	\$ 0.465	\$ 0.445
<b>Weighted average number of shares outstanding</b>				
Weighted average number of shares outstanding	2,825,116	2,843,514	2,825,323	2,845,454

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		Six Months Ended	
	June 30, 2008	2007	June 30, 2008	2007
Net income	\$ 2,446	\$ 1,760	\$ 4,467	\$ 3,140
Other comprehensive income:				
Unrealized losses on available for sale securities	(2,535)	(1,433)	(1,471)	(1,233)
Other comprehensive loss before tax	(2,535)	(1,433)	(1,471)	(1,233)
Income tax benefit related to other comprehensive income	(862)	(487)	(500)	(419)
Other comprehensive loss, net of tax	(1,673)	(946)	(971)	(814)
Comprehensive income	\$ 773	\$ 814	\$ 3,496	\$ 2,326

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



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

(in thousands)	Six Months Ended June 30,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 4,467	\$ 3,140
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	120	165
Depreciation and amortization	324	376
Amortization and accretion of investment securities	14	93
Deferred income taxes	18	(12)
Earnings on bank owned life insurance	(171)	(162)
Losses on sales or disposals of premises and equipment	-	100
Originations of loans held for sale	(3,522)	(3,198)
Proceeds from sales of loans held for sale	3,564	3,262
Gain on sale of foreclosed assets held for sale	-	(396)
Decrease (increase) in accrued interest receivable	(41)	75
Decrease in accrued interest payable	(248)	(201)
Other, net	49	275
Net cash provided by operating activities	4,574	3,517
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Available-for-sale securities:		
Proceeds from maturity and principal repayments of securities	7,965	5,848
Purchase of securities	(13,321)	(16,045)
Proceeds from redemption of regulatory stock	4,331	1,395
Purchase of regulatory stock	(3,027)	(965)
Net increase in loans	(5,247)	(229)
Purchase of premises and equipment	(98)	(273)
Proceeds from sale of foreclosed assets held for sale	-	1,075
Net cash used in investing activities	(9,397)	(9,194)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	29,100	21,426
Proceeds from long-term borrowings	14,107	6,638
Repayments of long-term borrowings	(10,793)	(3,500)
Net decrease in short-term borrowed funds	(23,594)	(16,531)
Purchase of treasury stock	(182)	(244)
Stock awards	42	13
Dividends paid	(1,314)	(1,255)
Net cash provided by financing activities	7,366	6,547
Net increase in cash and cash equivalents	2,543	870
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>10,389</b>	<b>10,015</b>

CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 12,932	\$ 10,885
Supplemental Disclosures of Cash Flow Information:		
Interest paid	\$ 7,157	\$ 8,673
Income taxes paid	\$ 1,190	\$ 410
Loans transferred to foreclosed property	\$ 273	\$ 61

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 organized as the holding company of its wholly owned subsidiary, First Citizens National Bank (the “Bank”), and the Bank’s subsidiary, First Citizens Insurance Agency, Inc. (“First Citizens Insurance”). All material inter-company balances and transactions have been eliminated in consolidation.

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

In the opinion of management of the Company, the accompanying interim financial statements for the quarters ended June 30, 2008 and 2007 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the period. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. The financial performance reported for the Company for the six-month period ended June 30, 2008 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, 2007.

Note 2 - Earnings per Share

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

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Net income applicable to common stock	\$2,446,000	\$1,760,000	\$4,467,000	\$3,140,000
Weighted average common shares outstanding	2,825,116	2,843,514	2,825,323	2,845,454
Earnings per share	\$0.87	\$0.62	\$1.58	\$1.10

Note 3 - 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 investments in tax credits.

Note 4 - Employee Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 10 of the Company's Consolidated Financial Statements included in the 2007 Annual Report on Form 10-K.

5

---

### Defined Benefit Plan

The Bank sponsors a noncontributory defined benefit pension plan covering substantially all employees and officers. The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plan's actuary.

The plan was amended, effective January 1, 2008, to cease eligibility for employees with a hire date of January 1, 2008 or later. In lieu of the pension plan, employees with a hire date of January 1, 2008 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 will be placed in a separate account within the 401(k) plan and will be subject to a vesting requirement.

The plan was also amended, effective January 1, 2008, for employees who are still eligible to participate. The amended 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 plan.

The following sets forth the components of net periodic benefit costs of the noncontributory defined benefit plan for the three months and six months ended June 30, 2008 and 2007, respectively (in thousands):

	Three Months Ended		Six Months Ended	
	2008	June 30, 2007	2008	June 30, 2007
Service cost	\$ 174	\$ 105	\$ 276	\$ 222
Interest cost	249	102	348	214
Expected return on plan assets	(316)	(117)	(429)	(246)
Net amortization and deferral	(2)	18	15	38
<b>Net periodic benefit cost</b>	<b>\$ 105</b>	<b>\$ 108</b>	<b>\$ 210</b>	<b>\$ 228</b>

The Company expects to contribute \$400,000 to its noncontributory defined benefit pension plan in 2008. As of June 30, 2008, the Company has contributed \$85,798.

### 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). The plan was amended, effective January 1, 2008. Under the amended plan, the Company's contributions are no longer required, but are dependent upon the contributions of the eligible employees. The Company's contributions vest immediately. Contributions by the Company totaled \$103,000 and \$98,000 for the six months ended June 30, 2008 and 2007, respectively.

### Note 5 – Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157, which, among other things, requires enhanced disclosures about assets and liabilities carried at fair value. SFAS No. 157 establishes 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 SFAS No. 157 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.

The following table presents the assets reported on the consolidated statements of financial condition at their fair value as of June 30, 2008 by level within the fair value hierarchy. As required by SFAS No. 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

(In thousands)	June 30, 2008			Total
	Level I	Level II	Level III	
Assets:				
Securities available for sale	\$ 404	\$ 124,270	\$ -	\$124,674

#### Note 6 – Recent Accounting Pronouncements

In December 2007, the FASB issued FAS No. 141 (revised 2007), Business Combinations (“FAS 141(R)”), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. FAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently evaluating the impact the adoption of this standard will have on the Company's results of operations.

In December 2007, the FASB issued FAS No. 160, Non-controlling Interests in Consolidated Financial Statements — an amendment of ARB No. 51. FAS No. 160 amends ARB No. 51 to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. FAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently evaluating the impact the adoption of this standard will have on the Company's results of operations.

In June 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-11 (“EITF 06-11”), Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. EITF 06-11 applies to share-based payment arrangements with dividend protection features that entitle employees to receive (a) dividends on equity-classified non-vested shares, (b) dividend equivalents on equity-classified non-vested share units, or (c) payments equal to the dividends paid on the underlying shares while an equity-classified share option is outstanding, when those dividends or dividend equivalents are charged to retained earnings under FAS No. 123R, Share-Based Payment, and result in an income tax deduction for the employer. A consensus was reached that a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified non-vested equity shares, non-vested equity share units, and outstanding equity share options should be recognized as an increase in additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of this standard will have on the Company’s results of operations.

In March 2008, the FASB issued FAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, to require enhanced disclosures about derivative instruments and hedging activities. The new standard has revised financial reporting for derivative instruments and hedging activities by requiring more transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities; and how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. FAS No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires entities to provide more information about their liquidity by requiring disclosure of derivative features that are credit risk-related. Further, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encourage. The Company is currently evaluating the impact the adoption of this standard will have on the Company’s results of operations.

In May 2008, the FASB issued FAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. FAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). FAS No. 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The Company does not expect the adoption of FAS No. 162 to have a material effect on its results of operations and financial position.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets (“FSP 142-3”). FSP 142-3 amends the factors that should be considered in developing assumptions about renewal or extension used in estimating the useful life of a recognized intangible asset under FAS No. 142, Goodwill and Other Intangible Assets. This standard is intended to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141R and other GAAP. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The measurement provisions of this standard will apply only to intangible assets of the Company acquired after the effective date.

In June 2008, the FASB issued FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities, to clarify that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of the FSP is that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. The provisions of this FSP are effective for financial statements issued for



fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented (including interim financial statements, summaries of earnings, and selected financial data) are required to be adjusted retrospectively to conform with the provisions of the FSP. The Company is currently evaluating the impact the adoption of the FSP will have on the Company's results of operations.

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

### Cautionary Statement

We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of Citizens Financial Services, Inc., First Citizens National Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use 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 would like to caution readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement:

- Interest rates could change more rapidly or more significantly than we expect.
- The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
  - The stock and bond markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.
- It could take us longer than we anticipate to implement strategic initiatives designed to increase revenues or manage expenses, or we may not be able to implement those initiatives at all.
  - Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.
- We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices, regulations or requirements, including the costs of compliance with such changes.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition. We could 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.

Additional factors that may affect our results are discussed in the Company's 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 significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for the Company. Our Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial conditions 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 and six months ended June 30, 2008 are not necessarily indicative of the results you may expect for the full year.



Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 16 banking facilities. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, the Wellsboro Weis Market store, and the Mansfield Wal-Mart Super Center. In New York, we have a branch office in Wellsville, Allegany County.

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

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

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

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

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

Readers should carefully review the risk factors described in other documents our Company files from time to time with the SEC, including the Annual Report on Form 10-K for the year ended December 31, 2007, filed by our Company and any current reports on Form 8-K filed by us.

We face strong competition in the communities that we serve from other commercial banks, savings banks, and savings and loan associations, some of which are substantially larger institutions than our subsidiary. In addition, insurance companies, investment-counseling firms, and other business firms and individuals offer personal and corporate trust services. We also compete with credit unions, issuers of money market funds, securities brokerage firms, consumer finance companies, mortgage brokers and insurance companies. These entities are strong competitors for virtually all types of financial services. The financial services industry continues to experience tremendous change to competitive barriers between bank and non-bank institutions. We must compete not only with traditional financial institutions, but also other business corporations that have begun to deliver competing financial services and banking services that are easily accessible through the internet. Competition for banking services is based on price, nature of product, quality of service, and in the case of certain activities, convenience of location.

## Trust and Investment Services

Our Investment and Trust Services Department is committed to helping our customers meet their financial goals. The Trust Department offers professional trust administration, investment management services, estate planning and administration, and custody of securities. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Company. Revenues and fees of the Trust Department are reflected in the Company's financial statements. As of June 30, 2008 and December 31, 2007, the Trust Department had \$90.6 and \$94.4 million of assets under management, respectively. The \$3.8 million decrease is primarily attributable to a decline in market values of trust assets since the end of the year.

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.

## Results of Operations

### Overview of the Income Statement

The Company had net income of \$4,467,000 for the first six months of 2008 compared with earnings of \$3,140,000 for last year's comparable period, an increase of \$1,327,000 or 42.3%. Earnings per share for the first six months of 2008 were \$1.58, compared to \$1.10 last year representing a 43.6% increase. Annualized return on assets and return on equity for the six months of 2008 were 1.50% and 17.80%, respectively, compared with 1.10% and 13.68% for last year's comparable period.

Net income for the three months ended June 30, 2008 totaled \$2,446,000 compared with \$1,760,000 for the comparable period last year, an increase of \$686,000 or 39.0%. Earnings per share for the three months ended June 30, 2008 and 2007 were \$.87 and \$.62 per share, respectively. Annualized return on assets and return on equity for the quarter ended June 30, 2008 was 1.64% and 19.24%, respectively, compared with 1.23% and 15.24% for last year's comparable period.

### Net Interest Income

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

Net interest income, for the first half of 2008, was \$11,238,000, an increase of \$2,125,000, compared to the same period in 2007. For the first six months of 2008, the provision for loan losses totaled \$120,000, compared to \$165,000 for 2007. Consequently, net interest income after the provision for loan losses was \$11,118,000, an increase of \$2,170,000, or 24.3% over the first six months of 2007.

For the three months ended June 30, 2008, net interest income was \$5,830,000, which was \$1,167,000 or 25.0% higher than the comparable period in 2007. The provision for loan losses for the second quarter this year was \$0 compared to \$45,000 in 2007. As such, net interest income after the provision for loan losses was \$5,830,000 compared to \$4,618,000 for the quarters ended June 30, 2008 and 2007, respectively.

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

11

---

Analysis of Average Balances and Interest Rates (1)  
Six Months Ended

	June 30, 2008			June 30, 2007		
	Average Balance (1) \$	Interest \$	Average Rate %	Average Balance (1) \$	Interest \$	Average Rate %
(dollars in thousands)						
<b>ASSETS</b>						
Short-term investments:						
Interest-bearing deposits at banks	708	7	1.92	3	-	4.98
Total short-term investments	708	7	1.92	3	-	4.98
Investment securities:						
Taxable	93,889	2,409	5.13	93,630	2,260	4.83
Tax-exempt (3)	33,867	1,043	6.16	22,607	680	6.02
Total investment securities	127,756	3,452	5.40	116,237	2,940	5.06
Loans:						
Residential mortgage loans	212,620	7,859	7.43	211,803	7,737	7.37
Commercial & farm loans	154,987	5,900	7.66	145,762	5,692	7.87
Loans to state & political subdivisions	46,886	1,471	6.31	44,911	1,344	6.03
Other loans	12,205	554	9.13	12,135	555	9.22
Loans, net of discount (2)(3)(4)	426,698	15,784	7.44	414,611	15,328	7.46
Total interest-earning assets	555,162	19,243	6.97	530,851	18,268	6.94
Cash and due from banks	9,148			9,213		
Bank premises and equipment	12,437			12,904		
Other assets	18,961			19,007		
Total non-interest earning assets	40,546			41,124		
Total assets	595,708			571,975		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest-bearing liabilities:						
NOW accounts	102,051	710	1.40	89,466	925	2.08
Savings accounts	39,764	73	0.37	38,280	65	0.34
Money market accounts	46,177	495	2.16	48,562	877	3.64
Certificates of deposit	224,300	4,393	3.94	233,334	4,873	4.21
Total interest-bearing deposits	412,292	5,671	2.77	409,642	6,740	3.32
Other borrowed funds	75,149	1,485	3.97	62,656	1,732	5.57
Total interest-bearing liabilities	487,441	7,156	2.95	472,298	8,472	3.62
Demand deposits	52,005			48,458		
Other liabilities	6,066			6,413		
Total non-interest-bearing liabilities	58,071			54,871		
Stockholders' equity	50,196			44,806		
Total liabilities & stockholders' equity	595,708			571,975		
Net interest income		12,087			9,796	

Net interest spread (5)	4.02%	3.32%
Net interest income as a percentage of average interest-earning assets	4.38%	3.72%
Ratio of interest-earning assets to interest-bearing liabilities	1.14	1.12

(1) Averages are based on daily averages.

(2) Includes loan origination and commitment fees.

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

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

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



Tax exempt revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Company's 34% Federal statutory rate. The following table represents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the periods ending June 30, 2008 and 2007:

(dollars in thousands)	For the Six Months	
	Ended June 30	
	2008	2007
Interest and dividend income		
from investment securities (non-tax adjusted)	\$ 3,085	\$ 2,689
Tax equivalent adjustment	374	251
Interest and dividend income		
from investment securities (tax equivalent basis)	\$ 3,459	\$ 2,940
Interest and fees on loans (non-tax adjusted)	\$ 15,309	\$ 14,896
Tax equivalent adjustment	475	432
Interest and fees on loans (tax equivalent basis)	\$ 15,784	\$ 15,328
Total interest income	\$ 18,394	\$ 17,585
Total interest expense	7,156	8,472
Net interest income	11,238	9,113
Total tax equivalent adjustment	849	683
Net interest income (tax equivalent basis)	\$ 12,087	\$ 9,796

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

	Six Months Ended June 30, 2008 vs. 2007 (1)		
	Change in Volume	Change in Rate	Total Change
<b>Interest Income:</b>			
<b>Short-term investments:</b>			
Interest-bearing deposits at banks	\$ 7	\$ -	\$ 7
<b>Investment securities:</b>			
Taxable	6	143	149
Tax-exempt	347	16	363
<b>Total investments</b>	<b>353</b>	<b>159</b>	<b>512</b>
<b>Loans:</b>			
Residential mortgage loans	36	86	122
Commercial & farm loans	372	(164)	208
Loans to state & political subdivisions	62	65	127
Other loans	1	(2)	(1)
<b>Total loans, net of discount</b>	<b>471</b>	<b>(15)</b>	<b>456</b>
<b>Total Interest Income</b>	<b>831</b>	<b>144</b>	<b>975</b>
<b>Interest Expense:</b>			
<b>Interest-bearing deposits:</b>			
NOW accounts	160	(375)	(215)
Savings accounts	3	5	8
Money Market accounts	(41)	(341)	(382)
Certificates of deposit	(179)	(301)	(480)
<b>Total interest-bearing deposits</b>	<b>(57)</b>	<b>(1,012)</b>	<b>(1,069)</b>
Other borrowed funds	560	(807)	(247)
<b>Total interest expense</b>	<b>503</b>	<b>(1,819)</b>	<b>(1,316)</b>
<b>Net interest income</b>	<b>\$ 328</b>	<b>\$ 1,963</b>	<b>\$ 2,291</b>

(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.

Our net interest spread improved from 3.32% for the six months ended June 30, 2007 to 4.02% for the same period in 2008. Since August 2007, the Federal Reserve has cut the Fed Funds rate by 325 basis points. During this time, the yield curve has steepened. For the first half of 2008, the rate cuts had a positive impact on the Company by reducing our short-term deposit and borrowing costs relative to the impact of the reduction of interest rates on our interest rate sensitive loan portfolio. As such, the Bank's interest margin has continued to improve. Management continues to review various pricing and investment strategies in an attempt to maintain or improve upon our current interest margin. Low cost core deposits continue to be our focus and are essential in improving the interest margin going forward.

Tax equivalent net interest income rose from \$9,796,000 in the first six months of 2007 to \$12,087,000 for the same period this year, increasing a total of \$2,291,000 over last year.

Total interest income increased \$975,000 for the six months ended June 30, 2008 compared to 2007. Of this, \$831,000 was due to volume as interest earning assets increased \$24.3 million. Tax-exempt investment securities

increased \$11.3 million since last year in an effort to manage our effective tax rate. A \$9.2 million increase in commercial and farm loans since 2007 shows our continued efforts in growing this segment. \$144,000 of the increase in interest income was due to rate primarily due to the yield on investment securities increasing 34 basis points which offset the slight decrease in the yield on our loan portfolio.

Total interest expense decreased \$1,316,000 for the six months ended June 30, 2008 compared with last year. The Federal Reserve's action to decrease rates, as mentioned above, had the effect of decreasing our average rates on certificates of deposit and on rate sensitive NOW and money market accounts. Comparing the first half of 2008 with 2007, the average interest rate on interest-bearing liabilities decreased 67 basis points, from 3.62% to 2.95%, which had the effect of decreasing interest expense by \$1,819,000. Offsetting this, interest-bearing liabilities increased \$15.1 million resulting in an increase in interest expense of \$503,000.

#### Provision For Loan Losses

For the six-month period ending June 30, 2008, we provided \$120,000 to the provision as a result of our quarterly review of the allowance for loan losses. The provision was less than the \$165,000 that was provided for the same time period in 2007. For the three month period ending June 30, 2008, no loan loss provision was provided compared to \$45,000 provided in 2007. Management's quarterly review of the allowance for loan losses is based on the following information: migration analysis of delinquent and non-accrual loans, impaired loans, estimated future losses on loans, recent review of large problem credits, local and national economic conditions, historical loss experience, qualitative adjustments, actual and expected loan growth and peer comparisons (see also "Financial Condition – Allowance for Loan Losses).

#### Non-interest Income

Non-interest income for the six months ended June 30, 2008, totaled \$2,527,000, a decrease of \$191,000 when compared to the same period in 2007. Gain on sales of foreclosed properties decreased by \$396,000 in 2008 due to a large commercial property that was sold for a gain in May, 2007. Service charge income increased by \$87,000 as it continues to be the primary source of non-interest income. For the first six months of 2008, account service charges totaled \$1,647,000 compared to \$1,560,000 last year. Approximately \$58,000 of the increase is attributable to customers' usage of their debit cards. Trust income also increased \$39,000 or 14.8% due to growth in our trust assets under management. Brokerage and insurance income increased \$69,000, or 140.8%, as we continue to grow the amount of dollars that customers choose to invest through us. Our focus has moved from annuity products to fee based managed accounts that will allow us to further develop our relationship with our customers.

For the three months ended June 30, 2008, non-interest income totaled \$1,318,000 compared to \$1,591,000 last year, a decrease of \$273,000. As mentioned above, gain on sales of foreclosed properties accounted for nearly all of the decrease of \$373,000. Similar to the six month analysis noted above, service charges for the three months ended June 30, 2008 increased \$59,000 due to increased revenue from customer debit card usage. Brokerage and insurance increased \$43,000 due to increased sales compared with last year.

The following tables show the breakdown of non-interest income for the three months and six months ended June 30, 2008 and 2007:

	Three months ended June 30,		Change	
	2008	2007	Amount	%
Service charges	\$ 871	\$ 812	\$ 59	7.3
Trust	136	127	9	7.1
Brokerage and insurance	74	31	43	138.7
Gain on sales of foreclosed properties	-	373	(373)	(100.0)
Earnings on bank owned life insurance	86	82	4	4.9
Other	151	166	(15)	(9.0)

Total	\$	1,318	\$	1,591	\$	(273)	(17.2)
-------	----	-------	----	-------	----	-------	--------

15

---

	Six months ended June 30,		Change	
	2008	2007	Amount	%
Service charges	\$ 1,647	\$ 1,560	\$ 87	5.6
Trust	303	264	39	14.8
Brokerage	118	49	69	140.8
Gains on sales of foreclosed properties	-	396	(396)	(100.0)
Earnings on bank owned life insurance	171	162	9	5.6
Other	288	287	1	0.3
Total	\$ 2,527	\$ 2,718	\$ (191)	(7.0)

### Non-interest Expense

Non-interest expenses increased \$120,000 or 1.6%, for the first six months of 2008, compared to the same period in 2007. The increase in salaries and employee benefits of \$188,000 is due mainly to annual merit increases and increases in incentive pay accruals this year compared with last year. Professional fees increased \$9,000 due to increased internal audit costs. There were modest decreases in occupancy, furniture and equipment, and other expenses over the first six months of 2008.

Non-interest expenses totaled \$3,938,000 for the three months ended June 30, 2008 compared to \$3,956,000 in 2007, a slight decrease of \$18,000. Salaries and employee benefits increased \$125,000, or 6.1%, for the three months ended due to the reasons mentioned above. Other expenses decreased \$97,000 primarily due to a one-time write down of a bank property in the amount of \$100,000 that was recorded in June of last year.

The following tables reflect the breakdown of non-interest expense and professional fees for the three months and six months ended June 30, 2008 and 2007:

	Three months ended June 30,		Change	
	2008	2007	Amount	%
Salaries and employee benefits	\$ 2,158	\$ 2,033	\$ 125	6.1
Occupancy	281	308	(27)	(8.8)
Furniture and equipment	128	140	(12)	(8.6)
Professional fees	148	155	(7)	(4.5)
Other	1,223	1,320	(97)	(7.3)
Total	\$ 3,938	\$ 3,956	\$ (18)	(0.5)

	Three months ended June 30,		Change	
	2008	2007	Amount	%
Other professional fees	\$ 79	\$ 72	\$ 7	9.7
Legal fees	20	42	(22)	(52.4)
Examinations and audits	49	41	8	19.5
Total	\$ 148	\$ 155	\$ (7)	(4.5)

	Six months ended June 30,		Change	
	2008	2007	Amount	%
Salaries and employee benefits	\$ 4,314	\$ 4,126	\$ 188	4.6
Occupancy	595	609	(14)	(2.3)
Furniture and equipment	261	268	(7)	(2.6)
Professional fees	329	320	9	2.8
Other	2,354	2,410	(56)	(2.3)
Total	\$ 7,853	\$ 7,733	\$ 120	1.6

	Six months ended June 30,		Change	
	2008	2007	Amount	%
Other professional fees	\$ 178	\$ 188	(10)	(5.3)
Legal fees	47	55	(8)	(14.5)
Examinations and audits	104	77	27	35.1
Total	\$ 329	\$ 320	\$ 9	2.8

#### Provision For Income Taxes

The provision for income tax was \$1,325,000 for the six-month period ended June 30, 2008 compared to \$793,000 for the same period in 2007, an increase of \$532,000 or 67.1%. Taxable income increased from \$3,933,000 in 2007 to \$5,792,000 in 2008, an increase of \$1,859,000, or 47.3%. The increase in taxable income has caused an increase in the provision for income taxes. Minimizing our effective tax rate remains a focus for management through the management of our municipal loan and bond portfolios. While our tax-exempt revenue has increased in 2008, it has not increased proportionally with the increase in taxable income. As such, our effective tax rate was 22.9% for the first six months this year versus 20.2% for the first six months of 2007.

We are involved in three limited partnership agreements that established low-income housing projects in our market areas. As a result of these agreements, for tax purposes we have recognized \$708,000 out of a total \$913,000 of tax credits from one project in the Towanda area that began in October of 2000. We have recognized \$250,000 out of a total \$385,000 of tax credits on the second project in the Wellsboro market which was completed in November 2001. In 2005, we entered into a third limited liability partnership for a low-income housing project for senior citizens in our Sayre market area. Beginning in 2007, we have recognized \$86,000 out of a total \$574,000 of tax credits. We anticipate recognizing \$828,000 of tax credits over the next nine years.

#### Financial Condition

Total assets of \$602.0 million at June 30, 2008 have increased 1.9% since year-end 2007's balance of \$591.0 million. Net loans increased 1.2% to \$424.1 million and investment securities increased 3.2% to \$124.7 million at June 30, 2008. Total deposits increased \$29.1 million or 6.4% to \$485.1 million since year-end 2007. Borrowed funds have decreased \$20.3 million to \$60.1 million compared with \$80.3 million at year-end.

#### Cash and Cash Equivalents

Cash and cash equivalents totaled \$12,932,000 at June 30, 2008 compared to \$10,389,000 at December 31, 2007. Non-interest-bearing cash increased \$2,557,000 since year-end 2007, while interest-bearing cash decreased \$14,000 during that same period. We believe the liquidity needs of the Company are satisfied by the current balance

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



## Investments

Our investment portfolio increased by \$3,872,000 or 3.2% from December 31, 2007 to June 30, 2008. During the first six months of 2008 we purchased approximately \$7.4 million of mortgage-backed securities, \$4.4 million of state and local obligations, and \$1.4 million of U.S. agency bonds which offset the \$6.4 million of principal repayments and \$1.6 million of maturities that have occurred during the same time period. The overall market value of our investment portfolio has also decreased approximately \$1.5 million due to market fluctuations as a result of various economic factors. For fixed maturity investments with unrealized losses due to changes in interest rates where the Company has both the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery, declines in value below cost are not assumed to be other than temporary. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an other than temporary impairment unless sufficient evidence is available that the decline is not permanent and a recovery period can be predicted. Based upon the Company's policy and management review, we have concluded that any impairment of its investment securities portfolio is not other than temporary and is the result of interest rate changes, sector credit rating changes, or company-specific changes that are not expected to result in the non-collection of principal and interest during the period.

We have extended the duration of our portfolio over the last year in order to take advantage of opportunities related to fluctuations and changes in the treasury curve and the resulting impact on bond yields. As a result, our investment portfolio is currently yielding 5.40% compared to 5.06% a year ago on a tax equivalent basis.

## Estimated Fair Market Value of Investment Portfolio

(dollars in thousands)	June 30, 2008		December 31, 2007	
	Amount	%	Amount	%
Available-for-sale:				
U. S. Agency securities	\$ 17,317	13.9	\$ 17,236	14.3
Obligations of state & political subdivisions	34,383	27.6	30,844	25.4
Corporate obligations	7,523	6.0	7,813	6.5
Mortgage-backed securities	63,403	50.9	62,642	51.9
Equity securities	2,048	1.6	2,267	1.9
Total	\$ 124,674	100.0	\$ 120,802	100.0

(dollars in thousands)	June 30, 2008/ December 31, 2007 Change	
	Amount	%
Available-for-sale:		
U. S. Agency securities	\$ 81	0.5
Obligations of state & political subdivisions	3,539	11.5
Corporate obligations	(290)	(3.7)
Mortgage-backed securities	761	1.2
Equity securities	(219)	(9.7)
Total	\$ 3,872	3.2

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 maintains

sufficient liquidity to satisfy depositor requirements and various credit needs of its customers.

#### Loans

The Company's lending is focused in the north central Pennsylvania market and the southern tier of New York. The composition of our loan portfolio consists principally of retail lending, which includes single-family residential mortgages and other consumer lending, and commercial lending primarily to locally-owned small businesses. New loans are generated primarily from direct loans to our existing customer base, with new customers generated by referrals from real estate brokers, building contractors, attorneys, accountants and existing customers.

18

---

As shown in the table below, total loans increased approximately \$5.1 million or 1.2% during the first half of 2008. Commercial real estate, construction, commercial and other loans, and state and political subdivision loans increased by \$1.2 million, \$9 million, \$5.1 million, and \$4.0 million, respectively. Residential real estate and consumer loans have decreased \$4.4 million and \$1.3 million, respectively.

The decrease in our residential real estate and loans to individuals during the first half of 2008 is due primarily to a decrease in loan demand related to several economic factors. Recessionary pressures, a softening economy, higher energy and food costs and a depressed housing market have all had a negative impact on our residential real estate loan growth. Additionally, we have continued to maintain our emphasis on sound credit underwriting standards. Despite the decrease, residential mortgage lending is a principal business activity and our Company continues to offer a full menu of competitively priced conforming, nonconforming and home equity mortgages.

The growth in commercial real estate and other commercial loans, despite the slowing economy, reflects on the Company's focus on commercial lending as a means to increase loan growth as well as obtain deposits from farmers and small businesses throughout our market area. We have a strong team of experienced professionals that enable us to meet the needs of these commercial customers within our service area. At the same time, we have increased our state and political loan portfolio. Our lenders have developed the expertise to meet the business needs of these unique customers while managing our effective tax rate by increasing tax-exempt revenue.

(in thousands)	June 30, 2008		December 31, 2007	
	Amount	%	Amount	%
Real estate:				
Residential	\$ 197,423	46.0	\$ 201,861	47.7
Commercial	101,559	23.7	100,380	23.7
Agricultural	16,477	3.8	16,891	4.0
Construction	12,249	2.9	11,330	2.7
Loans to individuals				
for household, family and other purchases	11,821	2.8	13,082	3.1
Commercial and other loans	39,718	9.3	34,664	8.2
State & political subdivision loans	49,184	11.5	45,171	10.6
Total loans	428,431	100.0	423,379	100.0
Less allowance for loan losses	4,287		4,197	
Net loans	\$ 424,144		\$ 419,182	

(in thousands)	June 30, 2008/ December 31, 2007	
	Amount	%
Real estate:		
Residential	\$ (4,438)	(2.2)
Commercial	1,179	1.2
Agricultural	(414)	(2.5)
Construction	919	8.1
Loans to individuals		
for household, family and other purchases	(1,261)	(9.6)
Commercial and other loans	5,054	14.6
State & political subdivision loans	4,013	8.9
Total loans	\$ 5,052	1.2



## Allowance For Loan Losses

The allowance for loan losses as a percentage of loans increased from .99% at December 31, 2007 to 1.00% at June 30, 2008. The dollar amount of the reserve increased \$90,000 since year-end 2007. The increase is a result of a \$120,000 provision for the first six months less net charge-offs. Gross charge-offs for the first six months of 2008 were \$54,000, while recoveries were \$24,000.

(in thousands)	June 30, 2008	2007	December 31, 2006	2005	2004
Balance, at beginning of period	\$ 4,197	\$ 3,876	\$ 3,664	\$ 3,919	\$ 3,620
Provision charged to income	120	365	330	60	-
Increase related to acquisition	-	-	-	-	290
Recoveries on loans previously charged against the allowance	24	142	172	57	324
	4,341	4,383	4,166	4,036	4,234
Loans charged against the allowance	(54)	(186)	(290)	(372)	(315)
Balance, at end of year	\$ 4,287	\$ 4,197	\$ 3,876	\$ 3,664	\$ 3,919
Allowance for loan losses as a percent of total loans	1.00%	0.99%	0.93%	0.96%	1.09%
Allowance for loan losses as a percent of non-performing loans	148.65%	191.64%	115.43%	163.94%	176.53%

The adequacy of the allowance for loan losses is subject to a formal analysis by management of the Company. Management deems the allowance to be adequate to absorb inherent losses probable in the portfolio, as of June 30, 2008. See the Company's Annual Report on Form 10-K for the year ended December 31, 2007 for a description of the process and methodology supporting the allowance for loan losses and any related provision for loan losses.

## Credit Quality Risk

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

(dollars in thousands)	June 30, 2008	2007	December 31, 2006	2005	2004
Non-performing loans:					
Non-accruing loans	\$ 671	\$ 827	\$ 478	\$ 867	\$ 722
Impaired loans	1,897	1,088	1,190	1,031	1,061
Accrual loans - 90 days or more past due	316	275	1,690	337	437
Total non-performing loans	2,884	2,190	3,358	2,235	2,220
Foreclosed assets held for sale	476	203	758	619	712
Total non-performing assets	\$ 3,360	\$ 2,393	\$ 4,116	\$ 2,854	\$ 2,932
Non-performing loans as a percent of loans net of unearned income	0.67%	0.52%	0.81%	0.58%	0.62%
Non-performing assets as a percent of loans net of unearned income	0.78%	0.57%	0.99%	0.75%	0.82%



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. Impaired loans increased by \$809,000 since December 31, 2007 primarily due to one commercial real estate relationship. Projected losses are minimal due to the collateral support of those loans.

#### Bank Owned Life Insurance

The Company has elected to purchase bank owned life insurance to offset future employee benefit costs. As of June 30, 2008 the cash surrender value of this life insurance is \$8,549,000, an increase of \$171,000 since December 31, 2007. The use of life insurance policies provides the Company with an asset that will generate earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits.

#### Deposits

Traditional deposits continue to be the most significant source of funds for the Company. Deposits increased \$29,101,000 or 6.4%, since December 31, 2007. The increase in deposits is due to several reasons. Our market area has been positively impacted from oil and gas exploration activities. We have developed targeted products to meet the needs of customers benefiting from this activity. The overall turbulence and volatility in the financial markets has resulted in customers seeking more stability in their deposits. Finally, our ability to work with local municipalities to meet their business needs has resulted in increased deposits.

As of June 30, 2008, non-interest-bearing deposits increased \$6,024,000, NOW accounts increased \$8,941,000, savings accounts increased \$2,981,000, and certificates of deposit increased by \$15,953,000. The increase in NOW accounts is predominantly from state and political deposits. Money market deposits decreased \$5,562,000 primarily due to customers seeking higher deposit rates due to the Federal Reserve's actions to decrease short-term rates. This includes \$3.9 million from one large customer shifting money from money market deposits to certificates of deposit.

(in thousands)	June 30, 2008		December 31, 2007	
	Amount	%	Amount	%
Non-interest-bearing deposits	\$ 56,968	11.8	\$ 50,944	11.2
NOW accounts	108,803	22.4	99,862	21.9
Savings deposits	40,977	8.5	37,996	8.3
Money market deposit accounts	45,836	9.4	51,398	11.3
Brokered certificates of deposit	6,969	1.4	6,205	1.3
Certificates of deposit	225,576	46.5	209,623	46.0
Total	\$ 485,129	100.0	\$ 456,028	100.0

(in thousands)	June 30, 2008/ December 31, 2007 Change	
	Amount	%
Non-interest-bearing deposits	\$ 6,024	11.8
NOW accounts	8,941	9.0
Savings deposits	2,981	7.8
Money market deposit accounts	(5,562)	(10.8)
Brokered certificates of deposit	764	12.3
Certificates of deposit	15,953	7.6

Total	\$ 29,101	6.4
-------	-----------	-----

21

---



## Borrowed Funds

Borrowed funds decreased \$20,281,000 during the first six months of 2008. The ability to grow our deposits was the main factor in decreasing the amount of our borrowed funds. The Company's daily cash requirements are primarily met by using the financial instruments available primarily through the Federal Home Loan Bank.

In December 2003, the Company formed a special purpose entity, Citizens Financial Statutory Trust I ("the Entity"), to issue \$7,500,000 of floating rate obligated mandatory redeemable securities as part of a pooled offering. The rate is determined quarterly and floats based on the 3 month LIBOR plus 2.80%. At June 30, 2008, the rate was 5.61%. The Entity may redeem them, in whole or in part, at face value after December 17, 2008. The Company borrowed the proceeds of the issuance from the Entity in December 2003 in the form of a \$7,500,000 note payable, which is included within "Borrowed Funds" in the liabilities section of the Company's balance sheet. Under current accounting rules, the Company's minority interest in the Entity was recorded at the initial investment amount and is included in the other assets section of the balance sheet. The Entity is not consolidated as part of the Company's consolidated financial statements.

## Stockholder's Equity

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

Total stockholders' equity was \$50,571,000 at June 30, 2008 compared to \$48,528,000, at December 31, 2007, an increase of \$2,043,000 or 4.2%. Excluding accumulated other comprehensive loss, stockholder's equity increased \$3,014,000, or 6.2%. In the first six months of 2008, the Company had net income of \$4,467,000 and paid dividends of \$1,314,000, representing a dividend payout ratio of 29.42%. The Company also purchased 7,937 shares of treasury stock at a weighted average cost of \$22.77 per share.

All of the Company's investment securities are classified as available-for-sale making this portion of the Company's balance sheet more sensitive to the changing market value of investments. Accumulated other comprehensive income decreased \$971,000 compared to December 31, 2007 as a result of market value fluctuations.

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

(dollars in thousands)	June 30, 2008		December 31, 2007	
Total capital (to risk-weighted assets)	Amount	Ratio	Amount	Ratio
Company	\$54,263	13.44%	\$51,320	13.00%
For capital adequacy purposes	32,290	8.00%	31,576	8.00%
To be well capitalized	40,362	10.00%	39,470	10.00%
Tier I capital (to risk-weighted assets)				
Company	\$49,976	12.38%	\$47,124	11.94%
For capital adequacy purposes	16,145	4.00%	15,788	4.00%

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

To be well capitalized	24,217	6.00%	23,682	6.00%
Tier I capital (to average assets)				
Company	\$49,976	8.50%	\$47,124	8.20%
For capital adequacy purposes	23,518	4.00%	22,979	4.00%
To be well capitalized	29,398	5.00%	28,723	5.00%

22

---

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

(dollars in thousands)	June 30, 2008		December 31, 2007	
	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)				
Bank	\$48,550	12.05%	\$45,456	11.53%
For capital adequacy purposes	32,234	8.00%	31,531	8.00%
To be well capitalized	40,292	10.00%	39,413	10.00%
Tier I capital (to risk-weighted assets)				
Bank	\$44,263	10.99%	\$41,260	10.47%
For capital adequacy purposes	16,117	4.00%	15,765	4.00%
To be well capitalized	24,175	6.00%	23,648	6.00%
Tier I capital (to average assets)				
Bank	\$44,263	7.50%	\$41,260	7.19%
For capital adequacy purposes	23,604	4.00%	22,959	4.00%
To be well capitalized	29,504	5.00%	28,699	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 at June 30, 2008 was as follows (dollars in thousands):

Commitments to extend credit	\$ 72,408
Standby letters of credit	5,942
	\$ 78,350

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing for business, personal or household use. The non-contractual amount of financial instruments with off-balance sheet risk at June 30, 2008 was \$11,262,000. The Company reserves the right to discontinue this service without prior notice.

#### Liquidity

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

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

Cash generated by operating activities, investing activities and financing activities influences liquidity management. The most important source of funds is the deposits that are primarily core deposits (deposits from customers with

other relationships). Short-term debt from the Federal Home Loan Bank supplements our Company's availability of funds as well as line of credit arrangements with correspondent banks. Other sources of short-term funds include brokered certificates of deposit and the sale of loans or investments, if needed.

Our Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other significant uses of funds include purchasing Regulatory Stock, as well as capital expenditures. Surplus funds are then invested in investment securities.

Capital expenditures during the first six months of 2008 were \$98,000, compared to \$273,000 during the same time period in 2007.

Our Company achieves additional liquidity primarily from temporary or short-term investments in the Federal Home Loan Bank (FHLB) of Pittsburgh, PA, and investments that mature in less than one year. The Company also has a maximum borrowing capacity at the FHLB of approximately \$225.3 million as an additional source of liquidity, of which \$44.7 million is outstanding.

#### 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, since our Company has no trading portfolio, it is not subject to trading risk.

Currently, our Company has equity securities that represent only 1.6% of our investment portfolio.

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 which are paid current market interest rates).

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

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

We use numerous interest rate simulations employing a variety of assumptions to evaluate our interest rate risk exposure. A shock analysis during the second quarter of 2008 indicated that a 200 basis point movement in interest rates in either direction would have a minor impact on our Company's anticipated net interest income over the next twenty-four months, well within our ability to manage effectively.

### 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”).

No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the Annual Report on Form 10-K for the period ended December 31, 2007.

### Item 4-Control 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.

### Changes to Internal Control Over Financial Reporting

There were no changes in the Company’s internal control over financial reporting during the three months ended June 30, 2008 that have materially affected, or are reasonably 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 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, 2007, which could materially affect our business, financial condition or future results. At June 30, 2008 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)
4/1/08 to 4/30/08	2	\$21.00	2	75,609
5/1/08 to 5/31/08	7,318	\$23.10	7,318	68,291
6/1/08 to 6/30/08	-	\$0.00	-	68,291
Total	7,320	\$23.10	7,320	68,291

(1) On January 7, 2006, the Board of Directors authorized the repurchase of 140,000 shares. The repurchase plan does not have an expiration date.

## Item 3 - Defaults Upon Senior Securities

Not applicable.





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

None

Item 5 - Other Information

None

27

---

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(1)
- 3.2 Bylaws of Citizens Financial Services, Inc.(2)
- 4.1 Instrument defining the rights of security holders – Common stock certificate(3)
- 4.2 No long term debt instrument issued by the Company exceeds 10% of consolidated assets or is registered. In accordance with paragraph 4(iii) of Item 601(b) of Regulation S-K, the Company will furnish the Securities and Exchange Commission copies of long-term debt instruments and related agreements upon request.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer
- 32.2 Section 1350 Certification of Chief Financial Officer

---

(1) Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, as filed with the Commission on May 11, 2000.

(2) Incorporated by reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003, as filed with the Commission on April 29, 2004.

(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.

Signatures

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

Citizens Financial Services, Inc.

Date: August 7, 2008

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

Date: August 7, 2008

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

