CITIZENS FINANCIAL SERVICES INC
Form 10-Q
May 10, 2006

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

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

For the quarterly period ended March 31, 2006

Or

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

For the transition period from____________________ to ___________________

Commission file number 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.)

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

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

Indicate by checkmark 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 __X__ No_____

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

Large Accelerated File ____ Accelerated Filer ____ Non-accelerated Filer __X__

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

The number of shares outstanding of the Registrant's Common Stock, as of May 1, 2006, 2,820,098 shares of Common Stock, par value $1.00.

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

(in thousands except share data)	**March 31 2006**	December 31 2005
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	**$ 9,781**	$ 8,498
Interest-bearing	**21**	111
Total cash and cash equivalents	**9,802**	8,609
Available-for-sale securities	**105,220**	102,602
Loans (net of allowance for loan losses of $3,709 and $3,664)	**385,116**	379,139
Premises and equipment	**12,195**	12,305
Accrued interest receivable	**2,316**	2,164
Goodwill	**8,605**	8,605
Core deposit intangible	**539**	684
Bank owned life insurance	**7,815**	7,743
Other assets	**8,595**	7,390
TOTAL ASSETS	**$ 540,203**	$ 529,241
LIABILITIES:		
Deposits:		
Noninterest-bearing	**$ 52,360**	$ 50,600
Interest-bearing	**375,087**	379,199
Total deposits	**427,447**	429,799
Borrowed funds	**67,042**	52,674
Accrued interest payable	**1,657**	1,862
Commitment to purchase investment securities	**-**	752
Other liabilities	**2,786**	2,593
TOTAL LIABILITIES	**498,932**	487,680
STOCKHOLDERS' EQUITY:		
Common Stock		
$1.00 par value; authorized 10,000,000 shares;		
issued 2,965,257 shares in 2006 and 2005, respectively	**2,965**	2,965
Additional paid-in capital	**11,359**	11,359
Retained earnings	**31,930**	31,251
TOTAL	**46,254**	45,575
Accumulated other comprehensive loss	**(1,942)**	(1,540)
Less: Treasury Stock, at cost 144,088 shares for 2006 and 118,715 for 2005, respectively	**(3,041)**	(2,474)
TOTAL STOCKHOLDERS' EQUITY	**41,271**	41,561
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**$ 540,203**	$ 529,241

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

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

(in thousands, except per share data)		Three Months Ended March 31, **2006**		2005
INTEREST INCOME:				
Interest and fees on loans	$	**6,519**	$	5,919
Investment securities:				
Taxable		**819**		792
Nontaxable		**226**		117
Dividends		**67**		51
TOTAL INTEREST INCOME		**7,631**		6,879
INTEREST EXPENSE:				
Deposits		**2,601**		2,168
Borrowed funds		**663**		378
TOTAL INTEREST EXPENSE		**3,264**		2,546
NET INTEREST INCOME		**4,367**		4,333
Provision for loan losses		**60**		-
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES		**4,307**		4,333
NON-INTEREST INCOME:				
Service charges		**706**		673
Trust		**129**		121
Brokerage		**58**		38
Insurance		**36**		83
Investment securities losses, net		**(6)**		-
Earnings on bank owned life insurance		**72**		74
Other		**137**		121
TOTAL NON-INTEREST INCOME		**1,132**		1,110
NON-INTEREST EXPENSES:				
Salaries and employee benefits		**2,036**		1,921
Occupancy		**308**		303
Furniture and equipment		**152**		175
Professional fees		**140**		145
Amortization		**144**		144
Other		**1,111**		1,143
TOTAL NON-INTEREST EXPENSES		**3,891**		3,831
Income before provision for income taxes		**1,548**		1,612
Provision for income taxes		**272**		345
NET INCOME	$	**1,276**	$	1,267
Earnings Per Share	$	**0.45**	$	0.44
Cash Dividend Declared	$	**0.21**	$	0.20
Weighted average number of shares outstanding		2,840,325		2,867,995

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

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

			Three Months Ended March 31			
(in thousands)			**2006**			2005
Net income		**$**	**1,276**		$	1,267
Other comprehensive loss:						
Unrealized losses on available for sale securities	**(614)**			(1,664)		
Less: Reclassification adjustment for losses included in net income	**6**			-		
Other comprehensive loss before tax			**(608)**			(1,664)
Income tax benefit related to other comprehensive loss			**(207)**			(566)
Other comprehensive loss, net of tax			**(401)**			(1,098)
Comprehensive income		**$**	**875**		$	169

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)	Three Months Ended March 31, **2006**	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 1,276**	$ 1,267
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**60**	-
Depreciation and amortization	**382**	370
Amortization and accretion of investment securities	**138**	188
Deferred income taxes	**(82)**	5
Investment securities losses, net	**6**	-
Earnings on bank owned life insurance	**(72)**	(74)
Originations of loans held for sale	**(589)**	(637)
Proceeds from sales of loans held for sale	**595**	647
Gain on sale of foreclosed assets held for sale	**(13)**	(9)
Increase in accrued interest receivable	**(152)**	(300)
Decrease in accrued interest payable	**(205)**	(238)
Other, net	**(90)**	115
Net cash provided by operating activities	**1,254**	1,334
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from sales of available-for-sale securities	**3,793**	-
Proceeds from maturity and principal repayments of securities	**3,878**	4,024
Purchase of securities	**(11,792)**	(4,739)
Proceeds from redemption of Regulatory Stock	**683**	715
Purchase of Regulatory Stock	**(1,269)**	(729)
Net increase in loans	**(6,174)**	(9,136)
Purchase of premises and equipment	**(81)**	(80)
Proceeds from sale of premises and equipment	**-**	200
Proceeds from sale of foreclosed assets held for sale	**50**	108
Net cash used in investing activities	**(10,912)**	(9,637)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net decrease in deposits	**(2,352)**	(5,850)
Proceeds from long-term borrowings	**288**	8,021
Repayments of long-term borrowings	**(71)**	-
Net increase in short-term borrowed funds	**14,151**	5,371
Purchase of Treasury Stock	**(567)**	-
Dividends paid	**(598)**	(568)
Net cash provided by financing activities	**10,851**	6,974

Net increase (decrease) in cash and cash equivalents		**1,193**		(1,329)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		**8,609**		9,339
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$**	**9,802**	$	8,010
Supplemental Disclosures of Cash Flow Information:				
Interest paid	**$**	**3,459**	$	2,776
Income taxes paid	**$**	**150**	$	-

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

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

Note 1 - Basis of Presentation

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

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

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

Note 2 - Earnings per Share

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

	Three months ended March 31,	
	2006	2005
Net income applicable to common stock	**$1,276,000**	$1,267,000
Weighted average common shares outstanding	**2,840,325**	2,867,995
Earnings per share	**$0.45**	$0.44

Note 3 - Income Tax Expense

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

Note 4 - Employee Benefit Plans

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

Defined Benefit Plan

The following sets forth the components of net periodic benefit costs of the noncontributory defined benefit plan for the three months ended March 31, 2006 and 2005, respectively (dollars presented in thousands):

	Pension Benefits	
	2006	2005
Service cost	**$ 91**	$ 68
Interest cost	**82**	60
Expected return on plan assets	**(95)**	(68)
Net amortization and deferral	**15**	6
Net periodic benefit cost	**$ 93**	$ 66

The Company previously disclosed in its financial statements for the year ended December 31, 2005, that it expected to contribute $340,000 to its noncontributory defined benefit pension plan in 2006. As of March 31, 2006, no contributions have been made.

Defined Contribution Plan

The Company also sponsors a defined contribution, 401(k) plan covering substantially all of its employees. The Company contributes three percent of applicable salaries into the plan. Contributions totaled $49,900 and $51,000 for the three months ended March 31, 2006 and 2005, respectively.

Note 5 - Recent Accounting Pronouncements

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

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

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

Cautionary Statement

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

- Interest rates could change more rapidly or more significantly than we expect.
- 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 implementing strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.
- Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.
- We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices, regulations or requirements, including the costs of compliance with such changes.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.

Introduction

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for Citizens Financial Service, Inc., a bank holding company and its subsidiary (the Company). Our Company's consolidated financial condition and results of operations consist almost entirely of our wholly owned subsidiary's (First Citizens National Bank) financial conditions and results of operations. Management's discussion and analysis should be read in conjunction with the preceding March 31, 2006 financial information. The results of operations for the three months ended March 31, 2006 and 2005 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 temporary banking office in Wellsville. A permanent banking facility is anticipated to be completed in late 2006. This marks the Company's first office location in New York.

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

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

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

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

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

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

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

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

Trust and Investment Services

Our Investment and Trust Services Department is committed to helping our customers meet their financial goals. The Trust Department offers professional trust administration, investment management services, estate planning and administration, and custody of securities. We also help the members of our communities prepare for retirement by providing retirement plans for local employers and by managing individual IRA accounts. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Company. As of March 31, 2006 and December 31, 2005, the Trust Department had $78.5 million and $75.2 million of assets under management, respectively.

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

Results of Operations

Overview of the Income Statement

The Company had net income of $1,276,000 for the first three months of 2006 compared with earnings of $1,267,000 for last year's comparable period, an increase of $9,000. Earnings per share for the first three months of 2006 were $0.45, compared to $.44 last year. Annualized return on assets and return on equity for the three months of 2006 was .96% and 11.84%, respectively, compared with 1.01% and 12.41% for last year's comparable period. Details of the reasons for this change are discussed on the following pages.

Net Interest Income

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

Net interest income, for the first quarter of 2006, after provision for loan losses, was $4,307,000, a decrease of $26,000, compared to the same period in 2005. For the first three months of 2006, the provision for losses totaled $60,000. For the first three months of 2005, the provision was $0.

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:

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Analysis of Average Balances and Interest Rates (1)

	March 31, 2006			March 31, 2005			March 31, 2004		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%	$	$	%
ASSETS									
Short-term investments:									
Interest-bearing deposits at banks	**8**	**-**	**4.36**	10	-	2.43	2,577	5	0.79
Total short-term investments	**8**	**-**	**4.36**	10	-	2.43	2,577	5	0.79
Investment securities:									
Taxable	**84,313**	**898**	**4.26**	89,605	854	3.81	95,711	973	4.07
Tax-exempt (3)	**23,117**	**342**	**5.92**	11,223	177	6.31	7,637	128	6.70
Total investment securities	**107,430**	**1,240**	**4.62**	100,828	1,031	4.09	103,348	1,101	4.26
Loans:									
Residential mortgage loans	**203,365**	**3,481**	**6.94**	197,447	3,321	6.82	187,097	3,301	7.16
Commercial & farm loans	**125,974**	**2,325**	**7.49**	115,222	1,950	6.86	81,063	1,384	6.92
Loans to state & political subdivisions	**43,318**	**640**	**5.99**	37,965	564	6.02	37,015	570	6.25
Other loans	**12,932**	**280**	**8.78**	12,367	270	8.85	12,634	284	9.12
Loans, net of discount (2)(3)(4)	**385,589**	**6,726**	**7.07**	363,001	6,105	6.82	317,809	5,539	7.07
Total interest-earning assets	**493,027**	**7,966**	**6.55**	463,839	7,136	6.24	423,734	6,645	6.36
Cash and due from banks	**8,606**			8,372			8,135		
Bank premises and equipment	**12,276**			11,769			10,592		
Other assets	**18,532**			18,789			18,617		
Total non-interest earning assets	**39,414**			38,930			37,344		
Total assets	**532,441**			502,769			461,078		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									
NOW accounts	**80,617**	**319**	**1.60**	68,324	114	0.68	58,341	48	0.33
Savings accounts	**38,899**	**29**	**0.30**	40,327	28	0.28	37,449	26	0.28
Money market accounts	**45,358**	**309**	**2.76**	43,880	157	1.45	44,273	103	0.94
Certificates of deposit	**212,394**	**1,944**	**3.71**	214,609	1,869	3.53	202,764	1,787	3.57
Total interest-bearing deposits	**377,268**	**2,601**	**2.80**	367,140	2,168	2.39	342,827	1,964	2.32

Other borrowed funds	**57,313**	**663**	**4.69**	46,137	378	3.32	32,805	213	2.63
Total interest-bearing liabilities	**434,581**	**3,264**	**3.05**	413,277	2,546	2.50	375,632	2,177	2.35
Demand deposits	**48,203**			44,128			43,169		
Other liabilities	**6,529**			4,513			4,287		
Total non-interest-bearing liabilities	**54,732**			48,641			47,456		
Stockholders' equity	**43,128**			40,851			37,990		
Total liabilities & stockholders' equity	**532,441**			502,769			461,078		
Net interest income		**4,702**			4,590			4,468	
Net interest spread (5)			**3.50%**			3.74%			4.01%
Net interest income as a percentage of average interest-earning assets			**3.87%**			4.01%			4.28%
Ratio of interest-earning assets to interest-bearing liabilities			**1.13**			1.12			1.13

(1) Averages are based on daily averages.
(2) Includes loan origination and commitment fees.
(3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%.
(4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.
(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Tax exempt revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Company's 34% Federal statutory rate. The following table represents the adjustment to convert net interest income to net interest on a fully taxable equivalent basis for the periods ending March 31, 2006 and 2005:

	For the Three Months Ended March 31, (dollars in thousands)	
	2006	2005
Total interest income	$ 7,631	$ 6,879
Total interest expense	3,264	2,546
Net interest income	4,367	4,333
Tax equivalent adjustment	335	257
Net interest income (fully taxable equivalent)	$ 4,702	$ 4,590

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

	2006 vs. 2005 (1)			2005 vs. 2004 (1)		
(in thousands)	**Change in Volume**	**Change in Rate**	**Total Change**	Change in Volume	Change in Rate	Total Change
Interest Income:						
Short-term investments:						
Interest-bearing deposits at banks	**$ -**	**$ -**	**$ -**	$ (8)	$ 3	$ (5)
Investment securities:						
Taxable	**(52)**	**96**	**44**	136	(255)	(119)
Tax-exempt	**177**	**(12)**	**165**	57	(8)	49
Total investments	**125**	**84**	**209**	193	(263)	(70)
Loans:						
Residential mortgage loans	**104**	**56**	**160**	178	(158)	20
Commercial & farm loans	**736**	**(361)**	**375**	578	(12)	566
Loans to state & political subdivisions	**79**	**(3)**	**76**	15	(21)	(6)
Other loans	**12**	**(2)**	**10**	(7)	(7)	(14)
Total loans, net of discount	**931**	**(310)**	**621**	764	(198)	566
Total Interest Income	**1,056**	**(226)**	**830**	949	(458)	491
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	**16**	**189**	**205**	7	59	66
Savings accounts	**(1)**	**2**	**1**	2	-	2
Money Market accounts	**5**	**147**	**152**	(1)	55	54
Certificates of deposit	**(19)**	**94**	**75**	103	(21)	82

Total interest-bearing deposits		**1**		**432**		**433**		111		93	204
Other borrowed funds		**38**		**247**		**285**		150		15	165
Total interest expense		**39**		**679**		**718**		261		108	369
Net interest income	**$**	**1,017**	**$**	**(905)**	**$**	**112**	$	688	$	(566)	$ 122

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

As can be seen from the preceding tables, we continue to experience a compression of our net interest margin. Due to the flattening of the yield curve, the net interest spread has decreased from 3.74% for the first three months of 2005 to 3.50% for the first three months of 2006. While short-term interest rates have increased nearly 375 basis points since June 2004, long-term rates have remained relatively stable. As such, our cost of funds (interest paid on deposits and borrowings) has increased while the rates earned on interest bearing assets have not increased accordingly and have in fact remained relatively flat. As the yield curve becomes steeper, away from a flatter yield curve, we would anticipate our interest margin to improve. We continue to review various pricing and investment strategies to enhance deposit growth while maintaining or improving the current interest margin.

Tax equivalent net interest income rose from $4,468,000 in 2004 to $4,590,000 in 2005, and increased to $4,702,000, in 2006. In the period ending March 31, 2006, net interest income increased $112,000 on a tax equivalent basis over the same period in 2005. The increased volume of interest-earning assets of $29.2 million generated an increase in interest income of $1,056,000 while the increased volume of interest-bearing liabilities of $21.3 million produced an additional $39,000 of interest expense. Combined, this resulted in an increase due to volume of $1,017,000 in net interest income.

Comparing the first quarter of 2006 with 2005, the yield on interest-earning assets increased 31 basis points from 6.24% to 6.55% and the average interest rate on interest-bearing liabilities increased 55 basis points, from 2.50% to 3.05%. As such, the net change in rate resulted in a negative $905,000 of net interest income primarily due to the flattened yield curve referred to above.

Provision For Loan Losses

For the three-month period ending March 31, 2006, we provided $60,000 to the provision as a result of our quarterly review of the allowance for loan losses. Management's quarterly review of the allowance for loan losses is based on the following information: migration analysis of delinquent and non-accrual loans, estimated future losses on loans, recent review of large problem credits, local and national economic conditions, historical loss experience, OCC qualitative adjustments and peer comparisons.

Non-interest Income

Non-interest income as detailed below increased $22,000 or 2.0%, for the first three months of 2006 when compared to the same period in 2005. Service charge income increased by $33,000 as it continues to be the primary source of non-interest income. For the first three months, account service charges totaled $706,000 compared to $673,000 last year. Most of this is attributable to the increase in NSF fees of $17,000 and an increase of $19,000 of fee income derived from customers’ usage of their debit cards. Brokerage income is up $20,000 from last year and insurance revenue is down $47,000 from 2005 due to a couple large annuity transactions early in 2005 that were not duplicated this year.

The following table shows the breakdown of non-interest income for the three months ended March 31, 2006 and 2005:

	Three months ended March 31,		Change	
(dollars in thousands)	**2006**	2005	Amount	%
Service charges	**$ 706**	$ 673	$ 33	4.9
Trust	**129**	121	8	6.6
Brokerage	**58**	38	20	52.6
Insurance	**36**	83	(47)	(56.6)
Investment securities losses, net	**(6)**	-	(6)	-
Earnings on bank owned life insurance	**72**	74	(2)	(2.7)
Other	**137**	121	16	13.2
Total	**$ 1,132**	$ 1,110	$ 22	2.0

We continue to evaluate means of increasing non-interest income. Our approach is to apply service charges on business transaction accounts by charging fees on transaction activity, reduced by earnings credit based on customers' balances, to more equitably recover costs. Additionally, we are focused on the continued growth of our Trust and brokerage areas as a means to service all of our customers financial needs and increase non-interest income.

Non-interest Expense

Total non-interest expense, as detailed below, increased $60,000 or 1.6%, for the first three months of 2006, compared to the same period in 2005. The increase in salaries and employee benefits of $115,000 is due mainly to merit increases and higher costs for health insurance and pension expense. Furniture and equipment costs are down due to decreased depreciation expense from assets becoming fully depreciated.

The following tables reflect the breakdown of non-interest expense and professional fees as of March 31, 2006 and 2005:

	Three months ended March 31,		Change	
(dollars in thousands)	**2006**	2005	Amount	%
Salaries and employee benefits	**$ 2,036**	$ 1,921	$ 115	6.0
Occupancy	**308**	303	5	1.7
Furniture and equipment	**152**	175	(23)	(13.1)
Professional fees	**140**	145	(5)	(3.4)
Amortization	**144**	144	-	-
Other	**1,111**	1,143	(32)	(2.8)
Total	**$ 3,891**	$ 3,831	$ 60	1.6

	Three months ended March 31,		Change	
(dollars in thousands)	**2006**	2005	Amount	%
Other professional fees	**$ 88**	$ 87	$ 1	1.1
Legal fees	**18**	17	1	5.9
Examinations and audits	**34**	41	(7)	(17.1)
Total	**$ 140**	$ 145	$ (5)	(3.4)

Provision For Income Taxes

The provision for income taxes was $272,000 for the three-month period ended March 31, 2006 compared to $345,000 for the same period in 2005. The decrease was primarily a result of our increase in tax-exempt municipal securities and municipal loans. We currently hold $22.9 million of municipal securities where as we held only approximately $12.0 million this time last year.

We have entered into two limited partnership agreements to establish low-income housing projects in our market area. As a result of these agreements for tax purposes, we have recognized $502,000 out of a total $911,000 of tax credits from one project and $163,608 out of a total $385,000 on the second project, which was completed in November 2001. A total of approximately $1,290,000 of tax credits is anticipated over a ten-year period. In 2005, we entered into a third limited liability partnership for a low-income housing project for senior citizens in our Sayre market area. We expect to recognize approximately $574,000 of tax credits over a ten year period beginning sometime in 2006.

Financial Condition

Total assets (shown in the Consolidated Balance Sheet) of $540.2 million have increased 2.1% since year-end 2005's balance of $529.2 million. Net loans increased 1.6% to $385.1 million and investment securities increased 2.6% to $105.2 million since year-end 2005. Total deposits decreased $2.4 million or .55% to $427.4 million since year-end 2005. Borrowed funds have increased $14.4 million to $67.0 million compared with $52.7 million at year-end.

Explanations of variances will be described within the following appropriate sections.

Cash and Cash Equivalents

Cash and cash equivalents totaled $9,802,000 at March 31, 2006 compared to $8,609,000 on December 31, 2005. Noninterest-bearing cash increased $1,283,000 since year-end 2005, while interest-bearing cash decreased $90,000 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

As shown in the table below, our investment portfolio increased by $2,618,000 or 2.6% from December 31, 2005 to March 31, 2006. During the first quarter of 2006 we purchased approximately $4.9 million of U.S. agency bonds, $4.9 million of mortgage-backed securities, and $1.2 million of tax-exempt municipal securities. Offsetting this, we continued to receive principal repayments in the amount of $2.6 million from our mortgaged backed securities portfolio as well as maturities in the amount of $1.2 million from our agency and municipal portfolios. We have also sold approximately $3.8 million of the portfolio in an effort to maximize our total return. The overall market value of our investment portfolio has also decreased approximately $.6 million due to increases in interest rates and the direct affect on our investment portfolio. Our investment portfolio is currently yielding 4.62% compared to 4.09% a year ago.

Estimated Fair Market Value of Investment Portfolio

	March 31, 2006			December 31, 2005		
(dollars in thousands)	Amount		%	Amount		%
Available-for-sale:						
U. S. Agency securities	**$**	**15,565**	**14.8**	$	12,754	12.5
Obligations of state & political subdivisions		**22,907**	**21.8**		22,612	22.0
Corporate obligations		**8,077**	**7.7**		8,627	8.4
Mortgage-backed securities		**55,739**	**53.0**		55,852	54.4
Other equity securities		**2,932**	**2.7**		2,757	2.7
Total	**$**	**105,220**	**100.0**	$	102,602	100.0

	March 31, 2006/ December 31, 2005 Change		
(dollars in thousands)	Amount		%
Available-for-sale:			
U. S. Agency securities	**$**	**2,811**	**22.0**
Obligations of state & political subdivisions		**295**	**1.3**
Corporate obligations		**(550)**	**(6.4)**
Mortgage-backed securities		**(113)**	**(0.2)**
Other equity securities		**175**	**6.3**
Total	**$**	**2,618**	**2.6**

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

Loans

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

As shown in the tables below (dollars in thousands), total loans increased approximately $6.0 million or 1.6% during the first quarter of 2006. Residential, commercial, and agricultural real estate loans increased $1.9 million, $2.6 million and $1.3 million, respectively. Municipal loans also increased by $.7 million. Offsetting these were decreases in construction real estate loans of $1.0 million.

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

	March 31, 2006			December 31, 2005		
(dollars in thousands)		Amount	%		Amount	%
Real estate:						
Residential	**$**	**197,496**	**50.8**	$	195,628	51.1
Commercial		**84,772**	**21.8**		82,128	21.5
Agricultural		**14,274**	**3.7**		12,991	3.4
Construction		**6,259**	**1.6**		7,245	1.9
Loans to individuals for household, family and other purchases		**13,006**	**3.3**		13,017	3.4
Commercial and other loans		**29,763**	**7.7**		29,260	7.6
State & political subdivision loans		**43,255**	**11.1**		42,534	11.1
Total loans		**388,825**	**100.0**		382,803	100.0
Less allowance for loan losses		**3,709**			3,664	
Net loans	**$**	**385,116**		$	379,139	

	March 31, 2006/ December 31, 2005 Change		
(dollars in thousands)		Amount	%
Real estate:			
Residential	**$**	**1,868**	**1.0**
Commercial		**2,644**	**3.2**
Agricultural		**1,283**	**9.9**
Construction		**(986)**	**(13.6)**
Loans to individuals for household, family and other purchases		**(11)**	**(0.1)**
Commercial and other loans		**503**	**1.7**
State & political subdivision loans		**721**	**1.7**
Total loans	**$**	**6,022**	**1.6**

Allowance For Loan Losses

As shown in the table below, the Allowance for Loan Losses as a percentage of loans decreased from .96% at December 31, 2005 to .95% at March 31, 2006. The dollar amount of the reserve increased $45,000 since year-end 2005. The increase is a result of a $20,000 monthly provision for the first three months less net charge-offs. Gross charge-offs for the first three months of 2006 were $26,000, while recoveries were $11,000.

	March 31,		December 31,		
(dollars in thousands)	2006	2005	2004	2003	2002
Balance, at beginning of period	$ 3,664	$ 3,919	$ 3,620	$ 3,621	$ 3,250
Provision charged to income	60	60	-	435	435
Increase related to acquisition	-	-	290	-	-
Recoveries on loans previously charged against the allowance	11	57	324	116	115
	3,735	4,036	4,234	4,172	3,800
Loans charged against the allowance	(26)	(372)	(315)	(552)	(179)
Balance, at end of year	$ 3,709	$ 3,664	$ 3,919	$ 3,620	$ 3,621
Allowance for loan losses as a percent of total loans	0.95%	0.96%	1.09%	1.14%	1.21%
Allowance for loan losses as a percent of non-performing loans	159.73%	163.94%	176.53%	134.62%	119.94%

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

Bank Owned Life Insurance

The Company has elected to purchase bank owned life insurance to offset future employee benefit costs. As of March 31, 2006 the cash surrender value of this life insurance is $7,815,000, an increase of $72,000 since year end. The use of life insurance policies provides the bank with an asset that will generate earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits.

Deposits

Traditional deposits continue to be the most significant source of funds for the Company. As shown in the following tables (dollars in thousands), deposits decreased $2,352,000 or .5%, since December 31, 2005. As of March 31, 2006, non-interest-bearing deposits increased by $1,760,000, savings accounts increased $2,265,000 and NOW accounts increased by $8,419,000. Most of the increase in NOW accounts is due to one large local governmental agency moving their account from a money market account to a NOW account during the quarter. Accordingly, money market deposit accounts decreased $9,509,000. Certificates of deposit declined by $5,287,000, mostly due to several local school district withdrawals totaling $6.2 million. These deposits were temporary in nature and the withdrawal was expected upon maturity.

(dollars in thousands)		**March 31, 2006** Amount	**%**		December 31, 2005 Amount	%
Non-interest-bearing deposits	**$**	**52,360**	**12.2**	$	50,600	11.8
NOW accounts		**81,967**	**19.2**		73,548	17.1
Savings deposits		**40,568**	**9.5**		38,303	8.9
Money market deposit accounts		**43,123**	**10.1**		52,632	12.2
Certificates of deposit		**209,429**	**49.0**		214,716	50.0
Total	**$**	**427,447**	**100.0**	$	429,799	100.0

(dollars in thousands)	**March 31, 2006/ December 31, 2005 Change** Amount	%