CITIZENS FINANCIAL SERVICES INC
Form 10-Q
November 09, 2006

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

(Mark One)

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

For the quarterly period ended September 30, 2006

Or

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

For the transition period from____________________ to ___________________

Commission File Number 000-13222

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

PENNSYLVANIA 23-2265045
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes __X__ No_____

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

Large accelerated filer ____ Accelerated filer ____ Non-accelerated filer __X__

Indicate by check mark 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 November 6, 2006; 2,826,970 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)		**September 30 2006**		December 31 2005
ASSETS:				
Cash and due from banks:				
Noninterest-bearing	$	9,616	$	8,498
Interest-bearing		26		111
Total cash and cash equivalents		9,642		8,609
Available-for-sale securities		103,301		102,602
Loans (net of allowance for loan losses: 2006, $3,841; 2005, $3,664)		407,769		379,139
Premises and equipment		12,574		12,305
Accrued interest receivable		2,407		2,164
Goodwill		8,605		8,605
Bank owned life insurance		7,967		7,743
Other assets		8,389		8,074
TOTAL ASSETS	$	560,654	$	529,241
LIABILITIES:				
Deposits:				
Noninterest-bearing	$	49,741	$	50,600
Interest-bearing		398,418		379,199
Total deposits		448,159		429,799
Borrowed funds		64,295		52,674
Accrued interest payable		1,994		1,862
Commitment to purchase investments		-		752
Other liabilities		2,628		2,593
TOTAL LIABILITIES		517,076		487,680
STOCKHOLDERS' EQUITY:				
Common Stock				
$1.00 par value; authorized 10,000,000 shares; issued				
2,992,896 shares in 2006 and 2,965,257 in 2005, respectively		2,993		2,965
Additional paid-in capital		11,933		11,359
Retained earnings		33,140		31,251
TOTAL		48,066		45,575
Accumulated other comprehensive loss		(1,018)		(1,540)
Less: Treasury Stock, at cost 162,674 shares for 2006 and 118,715 for 2005, respectively		(3,470)		(2,474)
TOTAL STOCKHOLDERS' EQUITY		43,578		41,561
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	560,654	$	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)

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

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

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)

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

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

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

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

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

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

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

Note 1 - Basis of Presentation

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

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

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

Note 2 - Earnings per Share

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

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

Note 3 - Income Tax Expense

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

Note 4 - Employee Benefit Plans

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

Defined Benefit Plan

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

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

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

Defined Contribution Plan

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

Note 5 - Recent Accounting Pronouncements

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

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

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

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

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

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

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

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

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

Cautionary Statement

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

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

Introduction

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

Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 16 banking facilities. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, the Wellsboro Weis Market store and the Mansfield Wal-Mart Super Center. In New York, we have completed construction of our first de novo branch office in the town of Wellsville. We began doing business in the new facility on October 30, 2006. This marks the Company’s first office location in New York.

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

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

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

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

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

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

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

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

Trust and Investment Services

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

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

Results of Operations

Overview of the Income Statement

For the three months ended September 30, 2006, The Company earned $1,548,000 in net income versus $1,318,000 in 2005, up $230,000, or 17.5%. Earnings per share for the third quarter was $0.55 compared to $0.46 in 2005. Annualized return on assets and return on equity for the third quarter was 1.12% and 14.03% compared to 1.03% and 12.55% in 2005.

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

Net Interest Income

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

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

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

Analysis of Average Balances and Interest Rates (1)

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

Total interest-bearing deposits	**383,477**	**8,390**	**2.93**	371,909	6,840	2.46	354,336	6,081	2.29
Other borrowed funds	**63,935**	**2,388**	**4.99**	41,192	1,140	3.70	34,966	684	2.62
Total interest-bearing liabilities	**447,412**	**10,778**	**3.22**	413,101	7,980	2.58			