

CITIZENS FINANCIAL SERVICES INC
Form 10-Q
May 08, 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 March 31, 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)

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

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, as of May 5, 2008, was 2,830,931 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 March 31, 2008 and December 31, 2007	1
	Consolidated Statement of Income for the Three Months Ended March 31, 2008 and 2007	2
	Consolidated Statement of Comprehensive Income for the Three Months Ended March 31, 2008 and 2007	3
	Consolidated Statement of Cash Flows for the Three Months Ended March 31, 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	9-23
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	24
Item 4.	Controls and Procedures	24
Part II	OTHER INFORMATION	
Item 1.	Legal Proceedings	25
Item 1A.	Risk Factors	25
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	25
Item 3.	Defaults upon Senior Securities	25
Item 4.	Submission of Matters to a Vote of Security Holders	26
Item 5.	Other Information	26
Item 6.	Exhibits	27
	Signatures	28

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

(in thousands except share data)	March 31 2008	December 31 2007
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	\$ 12,261	\$ 10,374
Interest-bearing	-	15
Total cash and cash equivalents	12,261	10,389
Available-for-sale securities	126,064	120,802
Loans (net of allowance for loan losses: 2008, \$4,305 and 2007, \$4,197)	420,918	419,182
Premises and equipment	12,408	12,538
Accrued interest receivable	2,755	2,522
Goodwill	8,605	8,605
Bank owned life insurance	8,463	8,378
Other assets	8,893	8,613
TOTAL ASSETS	\$ 600,367	\$ 591,029
LIABILITIES:		
Deposits:		
Noninterest-bearing	\$ 54,812	\$ 50,944
Interest-bearing	404,790	405,084
Total deposits	459,602	456,028
Borrowed funds	83,994	80,348
Accrued interest payable	1,939	2,199
Other liabilities	4,243	3,926
TOTAL LIABILITIES	549,778	542,501
STOCKHOLDERS' EQUITY:		
Common stock		
\$1.00 par value; authorized 10,000,000 shares; issued 3,020,538 shares at March 31, 2008 and December 31, 2007, respectively		
	3,020	3,020
Additional paid-in capital	12,511	12,511
Retained earnings	38,961	37,590
Accumulated other comprehensive income (loss)	355	(348)
Unearned restricted stock, at cost:		
3,149 shares at March 31, 2008 and December 31, 2007	(72)	(72)
Treasury stock, at cost: 195,500 shares at March 31, 2008 and 194,883 shares at December 31, 2007	(4,186)	(4,173)
TOTAL STOCKHOLDERS' EQUITY	50,589	48,528
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 600,367	\$ 591,029

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 March 31,	
	2008	2007
INTEREST INCOME:		
Interest and fees on loans	\$ 7,664	\$ 7,357
Investment securities:		
Taxable	1,123	1,014
Nontaxable	336	224
Dividends	85	91
TOTAL INTEREST INCOME	9,208	8,686
INTEREST EXPENSE:		
Deposits	2,943	3,309
Borrowed funds	857	926
TOTAL INTEREST EXPENSE	3,800	4,235
NET INTEREST INCOME	5,408	4,451
Provision for loan losses	120	120
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	5,288	4,331
NON-INTEREST INCOME:		
Service charges	776	748
Trust	167	138
Brokerage and insurance	44	19
Earnings on bank owned life insurance	85	79
Other	137	143
TOTAL NON-INTEREST INCOME	1,209	1,127
NON-INTEREST EXPENSES:		
Salaries and employee benefits	2,156	2,093
Occupancy	314	301
Furniture and equipment	133	128
Professional fees	181	165
Other	1,131	1,091
TOTAL NON-INTEREST EXPENSES	3,915	3,778
Income before provision for income taxes	2,582	1,680
Provision for income taxes	561	300
NET INCOME	\$ 2,021	\$ 1,380
Earnings Per Share	\$ 0.72	\$ 0.48
Cash Dividends Paid	\$ 0.23	\$ 0.22
Weighted average number of shares outstanding	2,825,529	2,847,416

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

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

(in thousands)	Three Months Ended March 31	
	2008	2007
Net income	\$ 2,021	\$ 1,380
Other comprehensive income:		
Unrealized gains on available for sale securities	1,065	200
Other comprehensive income, before tax	1,065	200
Income tax expense related to other comprehensive income	362	68
Other comprehensive income, net of tax	703	132
Comprehensive income	\$ 2,724	\$ 1,512

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	
	2008	March 31, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,021	\$ 1,380
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	120	120
Depreciation and amortization	172	194
Amortization and accretion of investment securities	9	52
Deferred income taxes	31	13
Earnings on bank owned life insurance	(85)	(79)
Originations of loans held for sale	(1,827)	(1,377)
Proceeds from sales of loans held for sale	1,849	1,395
Gain on sale of foreclosed assets held for sale	-	(23)
Increase in accrued interest receivable	(233)	(119)
Decrease in accrued interest payable	(260)	(120)
Other, net	(2)	(151)
Net cash provided by operating activities	1,795	1,285
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from maturity and principal repayments of securities	3,413	2,653
Purchase of securities	(7,619)	(2,082)
Proceeds from redemption of Regulatory Stock	1,609	473
Purchase of Regulatory Stock	(2,027)	(80)
Net (increase) decrease in loans	(1,806)	2,519
Purchase of premises and equipment	(50)	(188)
Proceeds from sale of foreclosed assets held for sale	-	80
Net cash (used in) provided by investing activities	(6,480)	3,375
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	3,574	10,533
Proceeds from long-term borrowings	4,021	5,706
Repayments of long-term borrowings	(8,514)	(3,000)
Net increase (decrease) in short-term borrowed funds	8,139	(19,795)
Purchase of Treasury Stock	(13)	(6)
Dividends paid	(650)	(620)
Net cash provided by (used in) financing activities	6,557	(7,182)
Net increase (decrease) in cash and cash equivalents	1,872	(2,522)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	10,389	10,015
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 12,261	\$ 7,493
Supplemental Disclosures of Cash Flow Information:		
Interest paid	\$ 4,060	\$ 4,355
Income taxes paid	\$ 150	\$ -

Loans transferred to foreclosed property	\$	-	\$	-
--	----	---	----	---

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.

In the opinion of management of the Company, the accompanying interim financial statements for the quarters ended March 31, 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 three-month period ended March 31, 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 to shareholders 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	
	March 31,	
	2008	2007
Net income applicable to common stock	\$2,021,000	\$1,380,000
Weighted average common shares outstanding	2,825,529	2,847,416
Earnings per share	\$0.72	\$0.48

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.

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 age and 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 calls for benefits to be paid to eligible employees based primarily upon years of service with the Bank 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 ended March 31, 2008 and 2007, respectively (in thousands):

	Pension Benefits	
	2008	2007
Service cost	\$ 102	\$ 104
Interest cost	99	99
Expected return on plan assets	(113)	(107)
Net amortization and deferral	17	24
Net periodic benefit cost	\$ 105	\$ 120

The Company expects to contribute \$403,000 to its noncontributory defined benefit pension plan in 2008. As of March 31, 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. 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 \$50,800 and \$53,500 for the three months ended March 31, 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 March 31, 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)	March 31, 2008			Total
	Level I	Level II	Level III	
Assets:				
Securities available for sale	\$ 381	\$ 125,683	\$ -	\$126,064

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.

7

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.

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 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 months ended March 31, 2008 and 2007 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 Securities and Exchange Commission, including the Annual Report 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 in addition, with 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 March 31, 2008 and December 31, 2007, the Trust Department had \$91.4 million and \$94.4 million of assets under management, respectively. The \$3.0 million decrease is primarily attributable to a decline in the market value of trust assets related to interest rate changes since the end of 2007.

Our Investment Representatives offer full service brokerage services throughout the Bank's market area, and appointments can be made at any 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.

Results of Operations

Overview of the Income Statement

The Company had net income of \$2,021,000 for the first three months of 2008 compared with earnings of \$1,380,000 for last year's comparable period, an increase of \$641,000 or 46.4%. Earnings per share for the first three months of 2008 were \$0.72, compared to \$.48 last year representing a 50.0% increase. Annualized return on assets and return on equity for the three months of 2008 were 1.36% and 16.32%, respectively, compared with .96% and 12.10% 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 quarter of 2008, was \$5,408,000, an increase of \$957,000, compared to the same period in 2007. For the first three months of 2008, the provision for loan losses totaled \$120,000, the same as 2007. Consequently, net interest income after the provision for loan losses was \$5,288,000, an increase of 22.1% over the first three months of 2007.

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)

(dollars in thousands)	March 31, 2008			March 31, 2007		
	Average Balance (1) \$	Interest \$	Average Rate %	Average Balance (1) \$	Interest \$	Average Rate %
ASSETS						
Short-term investments:						
Interest-bearing deposits at banks	1	-	2.01	4	-	4.75
Total short-term investments	1	-	2.01	4	-	4.75
Investment securities:						
Taxable	94,275	1,218	5.17	92,595	1,116	4.82
Tax-exempt (3)	33,147	510	6.15	22,584	339	6.00
Total investment securities	127,422	1,728	5.42	115,179	1,455	5.05
Loans:						
Residential mortgage loans	213,545	3,947	7.43	212,381	3,835	7.32
Commercial & farm loans	154,332	2,950	7.69	145,065	2,791	7.80
Loans to state & political subdivisions	45,080	711	6.34	45,021	671	6.04
Other loans	12,486	286	9.18	12,138	276	9.22
Loans, net of discount (2)(3)(4)	425,443	7,894	7.46	414,605	7,573	7.41
Total interest-earning assets	552,866	9,622	7.00	529,788	9,028	6.91
Cash and due from banks	8,886			9,096		
Bank premises and equipment	12,497			12,953		
Other assets	18,694			19,147		
Total non-interest earning assets	40,077			41,196		
Total assets	592,943			570,984		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
NOW accounts	98,474	394	1.61	85,225	424	2.02
Savings accounts	38,899	36	0.37	37,948	32	0.34
Money market accounts	46,538	291	2.51	48,372	436	3.66
Certificates of deposit	221,051	2,222	4.04	233,551	2,417	4.20
Total interest-bearing deposits	404,962	2,943	2.92	405,096	3,309	3.31
Other borrowed funds	82,796	857	4.16	67,594	926	5.56
Total interest-bearing liabilities	487,758	3,800	3.13	472,690	4,235	3.63
Demand deposits	49,568			47,580		
Other liabilities	6,092			6,216		
Total non-interest-bearing liabilities	55,660			53,796		
Stockholders' equity	49,525			44,498		
Total liabilities & stockholders' equity	592,943			570,984		
Net interest income		5,822			4,793	

Net interest spread (5)	3.87%	3.28%
Net interest income as a percentage of average interest-earning assets	4.24%	3.67%
Ratio of interest-earning assets to interest-bearing liabilities	1.13	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 March 31, 2008 and 2007:

	For the Three Months Ended March 31	
	2008	2007
Interest and dividend income		
from investment securities (non-tax adjusted)	\$ 1,544	\$ 1,329
Tax equivalent adjustment	184	126
Interest and dividend income		
from investment securities (tax equivalent basis)	\$ 1,728	\$ 1,455
Interest and fees on loans (non-tax adjusted)	\$ 7,664	\$ 7,357
Tax equivalent adjustment	230	216
Interest and fees on loans (tax equivalent basis)	\$ 7,894	\$ 7,573
Total interest income	\$ 9,208	\$ 8,686
Total interest expense	3,800	4,235
Net interest income	5,408	4,451
Total tax equivalent adjustment	414	342
Net interest income (tax equivalent basis)	\$ 5,822	\$ 4,793

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

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

	Change in Volume	2008 vs. 2007 (1) Change in Rate	Total Change
Interest Income:			
Short-term investments:			
Interest-bearing deposits at banks	\$ -	\$ -	\$ -
Investment securities:			
Taxable	21	81	102
Tax-exempt	162	9	171
Total investments	183	90	273
Loans:			
Residential mortgage loans	30	82	112
Commercial & farm loans	207	(48)	159
Loans to state & political subdivisions	1	39	40
Other loans	10	-	10
Total loans, net of discount	248	73	321
Total Interest Income	431	163	594
Interest Expense:			
Interest-bearing deposits:			
NOW accounts	99	(129)	(30)
Savings accounts	1	3	4
Money Market accounts	(16)	(129)	(145)
Certificates of deposit	(116)	(79)	(195)
Total interest-bearing deposits	(32)	(334)	(366)
Other borrowed funds	607	(676)	(69)
Total interest expense	575	(1,010)	(435)
Net interest income	\$ (144)	\$ 1,173	\$ 1,029

(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.

As can be seen from the preceding tables, our net interest spread improved from 3.28% for the three months ended March 31, 2007 to 3.87% for the same period in 2008. Since August 2007, the Federal Reserve has cut the Fed Funds rate by 300 basis points, the largest decline in a 26 week period since 1985. During this time, the yield curve has become relatively normal. For the quarter ended March 31, 2008, the rate cuts had a positive impact on the Company by decreasing our short-term cost of funds more than the decrease in interest income earned on shorter term interest earning assets. 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 \$4,702,000 in 2006 to \$4,793,000 in 2007, and increased to \$5,822,000, in 2008. In the period ending March 31, 2008, net interest income increased a total of \$1,029,000 on a tax equivalent basis over the same period in 2007. Total interest income increased \$594,000. Of this, \$431,000 was due to volume as interest earning assets increased \$23.1 million. \$163,000 of the increase in interest income was due to rate as the yield on interest earning assets increased 9 basis points from 6.91% to 7.00%.

Total interest expense decreased \$435,000 for the three months ended March 31, 2008 compared with last year. Comparing the first quarter of 2008 with 2007, the average interest rate on interest-bearing liabilities decreased 50 basis points, from 3.63% to 3.13%. This had the effect of decreasing interest expense by \$1,010,000. The actions of the Federal Reserve to decrease rates, as mentioned above, had the effect of decreasing our short-term borrowing costs as well as rates on deposit products, including shorter-term certificates of deposit and rate sensitive NOW and money market accounts. Offsetting this, interest-bearing liabilities increased \$15.1 million resulting in an increase of \$575,000.

Provision For Loan Losses

For the three-month period ending March 31, 2008, we provided \$120,000 to the provision as a result of our quarterly review of the allowance for loan losses. The provision equaled what was provided for the same time period 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, OCC 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 three months ended March 31, 2008, as detailed below, totaled \$1,209,000, an increase of \$82,000 when compared to the same period in 2007. Service charge income increased by \$28,000 as it continues to be the primary source of non-interest income. For the first three months of 2008, account service charges totaled \$776,000 compared to \$748,000 last year. Approximately \$25,000 of the increase is attributable to customers' usage of their debit cards. Trust income also increased \$29,000 or 21.0% due to our ongoing success in growing our trust assets under management. Brokerage and insurance income increased \$25,000 as we continue to manage the transition to a new broker-dealer. Our focus has moved from annuity products to fee based managed accounts that will allow us to further develop our relationship with our customers.

The following table shows the breakdown of non-interest income for the three months ended March 31, 2008 and 2007:

(dollars in thousands)	Three months ended		Change	
	2008	2007	Amount	%
Service charges	\$ 776	\$ 748	\$ 28	3.7
Trust	167	138	29	21.0
Brokerage and insurance	44	19	25	131.6
Earnings on bank owned life insurance	85	79	6	7.6
Other	137	143	(6)	(4.2)
Total	\$ 1,209	\$ 1,127	\$ 82	7.3

Non-interest Expense

Non-interest expenses, as detailed below, increased \$137,000 or 3.6%, for the first three months of 2008, compared to the same period in 2007. The increase in salaries and employee benefits of \$63,000 is due mainly to annual merit increases and increases in incentive pay accruals. Professional fees increased \$16,000 due to increased internal audit costs. There were modest increases in occupancy, furniture and equipment, and other expenses over the first three months of 2008.

The following tables reflect the breakdown of non-interest expense and professional fees as of March 31, 2008 and 2007:

(in thousands)	Three months ended		Change	
	2008	2007	Amount	%
Salaries and employee benefits	\$ 2,156	\$ 2,093	\$ 63	3.0
Occupancy	314	301	13	4.3
Furniture and equipment	133	128	5	3.9
Professional fees	181	165	16	9.7
Other	1,131	1,091	40	3.7
Total	\$ 3,915	\$ 3,778	\$ 137	3.6

(in thousands)	Three months ended		Change	
	2008	2007	Amount	%
Other professional fees	\$ 99	\$ 116	\$ (17)	(14.7)
Legal fees	27	13	14	107.7
Examinations and audits	55	36	19	52.8
Total	\$ 181	\$ 165	\$ 16	9.7

Provision For Income Taxes

The provision for income taxes was \$561,000 for the three-month period ended March 31, 2008 compared to \$300,000 for the same period in 2007. The increase is attributable primarily due to an increase in taxable income of \$902,000 for the comparable periods. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 21.6% for the first three months this year versus 17.8% for the first three 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 \$685,000 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 \$241,000 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 \$72,000 out of a total \$574,000 of tax credits. We anticipate recognizing \$875,000 of tax credits over the next nine years.

Financial Condition

Total assets of \$600.4 million at March 31, 2008 have increased 1.6% since year-end 2007's balance of \$591.0 million. Net loans increased .4% to \$420.9 million and investment securities increased 4.4% to \$126.1 million at March 31, 2008. Total deposits increased \$3.6 million or .8% to \$459.6 million since year-end 2007. Borrowed funds have increased \$3.6 million to \$84.0 million compared with \$80.3 million at year-end.

Cash and Cash Equivalents

Cash and cash equivalents totaled \$12,261,000 at March 31, 2008 compared to \$10,389,000 at December 31, 2007. Non-interest-bearing cash increased \$1,887,000 since year-end 2007, while interest-bearing cash decreased \$15,000 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 \$5,262,000 or 4.4% from December 31, 2007 to March 31, 2008. During the first quarter of 2008 we purchased approximately \$4.0 million of mortgage-backed securities and \$3.6 million of state and local obligations helping to offset the \$2.9 million of principal repayments and \$.5 million of maturities that have occurred during the same time period. The overall market value of our investment portfolio has also increased approximately \$1.0 million due to decreases in interest rates since year end. 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 5.42% compared to 5.05% a year ago on a tax equivalent basis.

Estimated Fair Market Value of Investment Portfolio

(dollars in thousands)	March 31, 2008		December 31, 2007	
	Amount	%	Amount	%
Available-for-sale:				
U. S. Agency securities	\$ 17,101	13.6	\$ 17,236	14.3
Obligations of state & political subdivisions	34,455	27.3	30,844	25.4
Corporate obligations	7,682	6.1	7,813	6.5
Mortgage-backed securities	64,574	51.2	62,642	51.9
Equity securities	2,252	1.8	2,267	1.9
Total	\$ 126,064	100.0	\$ 120,802	100.0

(dollars in thousands)	March 31, 2008/ December 31, 2007 Change	
	Amount	%
Available-for-sale:		
U. S. Agency securities	\$ (135)	(0.8)
Obligations of state & political subdivisions	3,611	11.7
Corporate obligations	(131)	(1.7)
Mortgage-backed securities	1,932	3.1
Equity securities	(15)	(0.7)
Total	\$ 5,262	4.4

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.

Total loans increased approximately \$1.8 million or .4% during the first quarter of 2008. Commercial real estate, construction, and commercial and other loans increased by \$.5 million, \$1.4 million, and \$2.7 million, respectively. Residential real estate, consumer and municipal loans have decreased \$1.8 million, \$.7 million, and \$.2 million, respectively.

There has been a decrease in loan demand due to several economic factors. Recessionary pressures and a depressed housing market have had a negative impact on residential real estate loan growth. 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 customers within our service area. Despite the slowdown in the first quarter, 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. We emphasize branch office personnel training and focus on providing flexibility and fast "turn around time" that will aid in growing our loan portfolio.

(dollars in thousands)	March 31, 2008		December 31, 2007	
	Amount	%	Amount	%
Real estate:				
Residential	\$ 200,073	47.0	\$ 201,861	47.7
Commercial	100,831	23.7	100,380	23.7
Agricultural	16,887	4.0	16,891	4.0
Construction	12,756	3.0	11,330	2.7
Loans to individuals				
for household, family and other purchases	12,412	2.9	13,082	3.1
Commercial and other loans	37,340	8.8	34,664	8.2
State & political subdivision loans	44,924	10.6	45,171	10.6
Total loans	425,223	100.0	423,379	100.0
Less allowance for loan losses	4,305		4,197	
Net loans	\$ 420,918		\$ 419,182	
	March 31, 2008/ December 31, 2007		Change	
(dollars in thousands)	Amount	%		
Real estate:				
Residential	\$ (1,788)	(0.9)		
Commercial	451			