

CITIZENS FINANCIAL SERVICES INC
Form 10-Q
May 11, 2009

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, 2009
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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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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 _____
__X__

Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of outstanding shares of the Registrant's Common Stock, as of May 8, 2009, was 2,846,202.

Citizens Financial Services, Inc.
Form 10-Q

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

| (in thousands except share data) | March 31 2009 | December 31 2008 |
|--|-------------------|---------------------|
| ASSETS: | | |
| Cash and due from banks: | | |
| Noninterest-bearing | \$ 10,677 | \$ 9,692 |
| Interest-bearing | 11,021 | 10,164 |
| Total cash and cash equivalents | 21,698 | 19,856 |
| Available-for-sale securities | 173,812 | 174,139 |
| Loans (net of allowance for loan losses: 2009, \$4,498 and 2008, \$4,378) | 433,080 | 428,436 |
| Premises and equipment | 11,631 | 12,762 |
| Accrued interest receivable | 3,345 | 2,912 |
| Goodwill | 10,256 | 10,256 |
| Bank owned life insurance | 12,296 | 12,176 |
| Other assets | 8,566 | 8,075 |
| TOTAL ASSETS | \$ 674,684 | \$ 668,612 |
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest-bearing | \$ 56,518 | \$ 55,545 |
| Interest-bearing | 498,058 | 491,135 |
| Total deposits | 554,576 | 546,680 |
| Borrowed funds | 56,764 | 61,204 |
| Accrued interest payable | 2,027 | 2,233 |
| Other liabilities | 6,878 | 5,725 |
| TOTAL LIABILITIES | 620,245 | 615,842 |
| STOCKHOLDERS' EQUITY: | | |
| Common stock | | |
| \$1.00 par value; authorized 10,000,000 shares; | | |
| issued 3,048,289 shares at March 31, 2009 and December 31, | | |
| 2008, respectively | 3,048 | 3,048 |
| Additional paid-in capital | 12,833 | 12,981 |
| Retained earnings | 42,697 | 41,034 |
| Accumulated other comprehensive income | 203 | 26 |
| Treasury stock, at cost: 202,087 shares at March 31, 2009 | | |
| and 200,918 shares at December 31, 2008 | (4,342) | (4,319) |
| TOTAL STOCKHOLDERS' EQUITY | 54,439 | 52,770 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 674,684 | \$ 668,612 |

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, | |
|--|---------------------------------|------------------|
| | 2009 | 2008 |
| INTEREST INCOME: | | |
| Interest and fees on loans | \$ 7,477 | \$ 7,664 |
| Interest-bearing deposits with banks | 2 | - |
| Investment securities: | | |
| Taxable | 1,640 | 1,123 |
| Nontaxable | 471 | 336 |
| Dividends | 7 | 85 |
| TOTAL INTEREST INCOME | 9,597 | 9,208 |
| INTEREST EXPENSE: | | |
| Deposits | 2,915 | 2,943 |
| Borrowed funds | 523 | 857 |
| TOTAL INTEREST EXPENSE | 3,438 | 3,800 |
| NET INTEREST INCOME | 6,159 | 5,408 |
| Provision for loan losses | 150 | 120 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 6,009 | 5,288 |
| NON-INTEREST INCOME: | | |
| Service charges | 812 | 776 |
| Trust | 163 | 167 |
| Brokerage and insurance | 100 | 44 |
| Investment securities gains, net | 16 | - |
| Earnings on bank owned life insurance | 121 | 85 |
| Other | 142 | 137 |
| TOTAL NON-INTEREST INCOME | 1,354 | 1,209 |
| NON-INTEREST EXPENSES: | | |
| Salaries and employee benefits | 2,296 | 2,156 |
| Occupancy | 321 | 314 |
| Furniture and equipment | 110 | 133 |
| Professional fees | 131 | 181 |
| Other | 1,514 | 1,131 |
| TOTAL NON-INTEREST EXPENSES | 4,372 | 3,915 |
| Income before provision for income taxes | 2,991 | 2,582 |
| Provision for income taxes | 645 | 561 |
| NET INCOME | \$ 2,346 | \$ 2,021 |
| Earnings Per Share | \$ 0.82 | \$ 0.71 |
| Cash Dividends Paid | \$ 0.24 | \$ 0.23 |
| Weighted average number of shares outstanding | 2,844,512 | 2,853,280 |

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 | |
|--|--------------------------------|----------|
| | 2009 | 2008 |
| Net income | \$ 2,346 | \$ 2,021 |
| Other comprehensive income: | | |
| Unrealized gains on available for sale securities | 270 | 1,065 |
| Change in unrealized gain on interest rate swap | 14 | - |
| Less: Reclassification adjustment for gain included in net income | (16) | - |
| Other comprehensive income, before tax | 268 | 1,065 |
| Income tax expense related to other comprehensive income | 91 | 362 |
| Other comprehensive income, net of tax | 177 | 703 |
| Comprehensive income | \$ 2,523 | \$ 2,724 |

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 | |
|---|--------------------|----------|
| | 2009 | 2008 |
| | March 31, | |
| | 2009 | 2008 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 2,346 | \$ 2,021 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 150 | 120 |
| Depreciation and amortization | 163 | 172 |
| Amortization and accretion of investment securities | 21 | 9 |
| Deferred income taxes | (9) | 31 |
| Investment securities gains, net | (16) | - |
| Earnings on bank owned life insurance | (121) | (85) |
| Originations of loans held for sale | (3,829) | (1,827) |
| Proceeds from sales of loans held for sale | 3,877 | 1,849 |
| Loss on sale of foreclosed assets held for sale | 15 | - |
| Increase in accrued interest receivable | (433) | (233) |
| Decrease in accrued interest payable | (206) | (260) |
| Other, net | 622 | (2) |
| Net cash provided by operating activities | 2,580 | 1,795 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Available-for-sale securities: | | |
| Proceeds from sales of available-for-sale securities | 2,178 | - |
| Proceeds from maturity and principal repayments of securities | 10,796 | 3,413 |
| Purchase of securities | (12,398) | (7,619) |
| Proceeds from redemption of Regulatory Stock | - | 1,609 |
| Purchase of Regulatory Stock | (61) | (2,027) |
| Net increase in loans | (4,902) | (1,806) |
| Purchase of premises and equipment | (433) | (50) |
| Proceeds from sale of premises and equipment | 1,405 | - |
| Proceeds from sale of foreclosed assets held for sale | 75 | - |
| Net cash used in investing activities | (3,340) | (6,480) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in deposits | 7,896 | 3,574 |
| Proceeds from long-term borrowings | 1,185 | 4,021 |
| Repayments of long-term borrowings | (7,028) | (8,514) |
| Net increase in short-term borrowed funds | 1,403 | 8,139 |
| Purchase of Treasury Stock | (187) | (13) |
| Reissuance of Treasury Stock | 16 | - |
| Dividends paid | (683) | (650) |
| Net cash provided by financing activities | 2,602 | 6,557 |
| Net increase in cash and cash equivalents | 1,842 | 1,872 |

| | | |
|--|-----------|-----------|
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 19,856 | 10,389 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 21,698 | \$ 12,261 |
| Supplemental Disclosures of Cash Flow Information: | | |
| Interest paid | \$ 3,534 | \$ 4,060 |
| Income taxes paid | \$ 50 | \$ 150 |
| Loans transferred to foreclosed property | \$ 147 | \$ - |

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”).

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) and in conformity with U.S. generally accepted accounting principles. Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. Certain of the prior year amounts have been reclassified to conform with the current year presentation. Such reclassifications had no effect on net income or stockholders’ equity. All material inter-company balances and transactions have been eliminated in consolidation.

In the opinion of management of the Company, the accompanying interim financial statements for the quarters ended March 31, 2009 and 2008 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, 2009 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, 2008.

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, 2009 2008 | |
|--|---|-------------|
| Net income applicable to common stock | \$2,346,000 | \$2,021,000 |
| Weighted average common shares outstanding | 2,844,512 | 2,853,280 |
| Earnings per share | \$0.82 | \$0.71 |

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 2008 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 length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount will be placed in a separate account within the 401(k) plan and will be subject to a vesting requirement.

The plan was also amended, effective January 1, 2008, for employees who are still eligible to participate. The amended plan requires benefits to be paid to eligible employees based primarily upon age and compensation rates during employment. Upon retirement or other termination of employment, employees can elect either an annuity benefit or a lump sum distribution of vested benefits in the plan.

The following sets forth the components of net periodic benefit costs of the noncontributory defined benefit plan for the three months ended March 31, 2009 and 2008, respectively (in thousands):

| | Pension Benefits | |
|--------------------------------|------------------|--------|
| | 2009 | 2008 |
| Service cost | \$ 115 | \$ 102 |
| Interest cost | 144 | 99 |
| Expected return on plan assets | (178) | (113) |
| Net amortization and deferral | 6 | 17 |
| Net periodic benefit cost | \$ 87 | \$ 105 |

The Company expects to contribute \$400,000 to its noncontributory defined benefit pension plan in 2009. As of March 31, 2009, the Company has contributed \$0.

Defined Contribution Plan

The Company sponsors a voluntary 401(k) savings plan which eligible employees can elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). The plan was amended, effective January 1, 2008. Under the amended plan, the Company's contributions are no longer required, but are dependent upon the contributions of the eligible employees. The Company's contributions vest immediately. Contributions by the Company totaled \$49,500 and \$50,800 for the three months ended March 31, 2009 and 2008, 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:

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- 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, 2009 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, 2009 | | | Total |
|---|----------------|-----------|-----------|-----------|
| | Level I | Level II | Level III | |
| Assets: | | | | |
| Fair value measurements on recurring basis: | | | | |
| Securities available for sale | \$ 257 | \$173,555 | \$ - | \$173,812 |
| Fair value measurements on non-recurring basis: | | | | |
| Impaired Loans | \$ - | \$ 688 | \$ - | \$ 688 |

Note 6 – Recent Accounting Pronouncements

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets (“FSP 142-3”). FSP 142-3 amends the factors that should be considered in developing assumptions about renewal or extension used in estimating the useful life of a recognized intangible asset under FAS No. 142, Goodwill and Other Intangible Assets. This standard is intended to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141R and other GAAP. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The measurement provisions of this standard will apply only to intangible assets of the Company acquired after the effective date. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In June 2008, the FASB issued FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities, to clarify that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of the FSP is that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. The provisions of this FSP are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data

presented (including interim financial statements, summaries of earnings, and selected financial data) are required to be adjusted retrospectively to conform with the provisions of the FSP. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

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In April 2009, the FASB issued FSP No. FAS 141(R)-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies. This FSP requires companies acquiring contingent assets or assuming contingent liabilities in business combination to either (a) if the assets' or liabilities' fair value can be determined, recognize them at fair value, at the acquisition date, or (b) if the assets' or liabilities' fair value cannot be determined, but (i) it is probable that an asset existed or that a liability had been incurred at the acquisition date and (ii) the amount of the asset or liability can be reasonably estimated, recognize them at their estimated amount, at the acquisition date. If the fair value of these contingencies cannot be determined and they are not probable or cannot be reasonably estimated, then companies should not recognize these contingencies as of the acquisition date and instead should account for them in subsequent periods by following other applicable GAAP. This FSP also eliminates the FAS 141R requirement of disclosing in the footnotes to the financial statements the range of expected outcomes for a recognized contingency. This FSP shall be effective for assets or liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In April 2009, the FASB issued FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. This FSP relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. FSP No. FAS 157-4 is effective for interim and annual periods ending after June 15, 2009, but entities may early adopt this FSP for the interim and annual periods ending after March 15, 2009. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. FSP No. FAS 107-1 and APB 28-1 is effective for interim and annual periods ending after June 15, 2009, but entities may adopt this FSP earlier for the interim and annual periods ending after March 15, 2009. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, which provides additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities. FSP No. FAS 115-2 and FAS 124-2 is effective for interim and annual periods ending after June 15, 2009, but entities may adopt this FSP earlier for the interim and annual periods ending after March 15, 2009. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

Note 7 – Branch Acquisition

On November 21, 2008, the Company acquired the Mansfield branch of the Elmira Savings Bank located in Mansfield, Pennsylvania. The acquisition included retail deposits of \$16,889,000 and loans of \$267,000. Land, building and certain other fixed assets were acquired with an appropriate fair market value of \$296,000. The Company also recorded goodwill of \$1,651,000 and \$67,000 of core deposit intangible. Upon completion of the acquisition, the Bank had approximately 40% of the deposit market share in Tioga County.

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

Cautionary Statement

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

- Interest rates could change more rapidly or more significantly than we expect.
- The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
 - The stock and bond markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.
- It could take us longer than we anticipate to implement strategic initiatives designed to increase revenues or manage expenses, or we may not be able to implement those initiatives at all.
 - Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.
- We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices, regulations or requirements, including the costs of compliance with such changes.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition. We could also experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.

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

Introduction

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for the Company. Our Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three months ended March 31, 2009 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 17 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 November 2008, we completed the acquisition of another Mansfield location from The Elmira Savings Bank, FSB (see Footnote 7 to the Consolidated Financial Statements). In New York, we have a branch office in Wellsville, Allegany County.

Risk Management

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

Competition

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 the Bank. In addition, insurance companies, investment-counseling firms, and other business firms and individuals offer personal and corporate trust services. We also compete with credit unions, issuers of money market funds, securities brokerage firms, consumer finance companies, mortgage brokers and insurance companies. These entities are strong competitors for virtually all types of financial services. The financial services industry continues to experience tremendous change to competitive barriers between bank and non-bank institutions. We must compete not only with traditional financial institutions, but also other business corporations that have begun to deliver competing financial services and banking services that are easily accessible through the internet. Competition for banking services is primarily based on price, nature of product, quality of service, and convenience of location.

Trust and Investment Services

Our Investment and Trust Services 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, 2009 and December 31, 2008, the Trust Department had \$71.8 and \$74.3 million of assets under management, respectively. The \$2.5 million decrease is primarily attributable to a decline in market values of trust assets since the end of the year.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance. Fee income from the sale of these products is reflected in the Company's financial statements.

Results of Operations

Overview of the Income Statement

The Company had net income of \$2,346,000 for the first three months of 2009 compared with earnings of \$2,021,000 for last year's comparable period, an increase of \$325,000 or 16.1%. Earnings per share for the first three months of 2009 were \$0.82, compared to \$.71 last year, representing a 15.5% increase. Annualized return on assets and return on equity for the three months of 2009 were 1.41% and 17.59%, respectively, compared with 1.36% and 16.32% for last year's comparable period.

Net Interest Income

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

Net interest income, for the first quarter of 2009, was \$6,159,000, an increase of \$751,000, or 13.9%, compared to the same period in 2008. For the first three months of 2009, the provision for loan losses totaled \$150,000, an increase of \$30,000 over 2008. Consequently, net interest income after the provision for loan losses was \$6,009,000 compared to \$5,288,000 during the first three months of 2008.

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, 2009 | | | March 31, 2008 | | |
|---|------------------------------|----------------|----------------------|------------------------------|----------------|----------------------|
| | Average Balance (1) \$ | Interest \$ | Average Rate % | Average Balance (1) \$ | Interest \$ | Average Rate % |
| ASSETS | | | | | | |
| Short-term investments: | | | | | | |
| Interest-bearing deposits at banks | 8,417 | 2 | 0.08 | 1 | - | 2.01 |
| Total short-term investments | 8,417 | 2 | 0.08 | 1 | - | 2.01 |
| Investment securities: | | | | | | |
| Taxable | 130,276 | 1,648 | 5.06 | 94,275 | 1,218 | 5.17 |
| Tax-exempt (3) | 44,783 | 714 | 6.38 | 33,147 | 510 | 6.15 |
| Total investment securities | 175,059 | 2,362 | 5.40 | 127,422 | 1,728 | 5.42 |
| Loans: | | | | | | |
| Residential mortgage loans | 206,812 | 3,747 | 7.35 | 213,545 | 3,947 | 7.43 |
| Commercial & farm loans | 171,048 | 2,981 | 7.07 | 154,332 | 2,950 | 7.69 |
| Loans to state & political subdivisions | 47,240 | 734 | 6.30 | 45,080 | 711 | 6.34 |
| Other loans | 11,276 | 251 | 9.03 | 12,486 | 286 | 9.21 |
| Loans, net of discount (2)(3)(4) | 436,376 | 7,713 | 7.17 | 425,443 | 7,894 | 7.46 |
| Total interest-earning assets | 619,852 | 10,077 | 6.59 | 552,866 | 9,622 | 7.00 |
| Cash and due from banks | 8,929 | | | 8,886 | | |
| Bank premises and equipment | 11,770 | | | 12,497 | | |
| Other assets | 27,297 | | | 18,694 | | |
| Total non-interest earning assets | 47,996 | | | 40,077 | | |
| Total assets | 667,848 | | | 592,943 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 115,010 | 248 | 0.87 | 98,474 | 394 | 1.61 |
| Savings accounts | 44,899 | 37 | 0.33 | 38,899 | 36 | 0.37 |
| Money market accounts | 40,627 | 99 | 0.99 | 46,538 | 291 | 2.51 |
| Certificates of deposit | 293,675 | 2,531 | 3.50 | 221,051 | 2,222 | 4.04 |
| Total interest-bearing deposits | 494,211 | 2,915 | 2.39 | 404,962 | 2,943 | 2.92 |
| Other borrowed funds | 57,691 | 523 | 3.68 | 82,796 | 857 | 4.16 |
| Total interest-bearing liabilities | 551,902 | 3,438 | 2.53 | 487,758 | 3,800 | 3.13 |
| Demand deposits | 54,013 | | | 49,568 | | |
| Other liabilities | 8,567 | | | 6,092 | | |
| Total non-interest-bearing liabilities | 62,580 | | | 55,660 | | |
| Stockholders' equity | 53,366 | | | 46,525 | | |
| Total liabilities & stockholders' equity | 667,848 | | | 589,943 | | |
| Net interest income | | 6,639 | | | 5,822 | |
| Net interest spread (5) | | | 4.06% | | | 3.87% |

| | | |
|--|-------|-------|
| Net interest income as a percentage of average interest-earning assets | 4.34% | 4.24% |
| Ratio of interest-earning assets to interest-bearing liabilities | 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 income on a fully taxable equivalent basis for the periods ending March 31, 2009 and 2008:

| | For the Three Months Ended March 31 | |
|---|--|----------|
| | 2009 | 2008 |
| Interest and dividend income | | |
| from investment securities (non-tax adjusted) | \$ 2,120 | \$ 1,544 |
| Tax equivalent adjustment | 244 | 184 |
| Interest and dividend income | | |
| from investment securities (tax equivalent basis) | \$ 2,364 | \$ 1,728 |
| Interest and fees on loans (non-tax adjusted) | \$ 7,477 | \$ 7,664 |
| Tax equivalent adjustment | 236 | 230 |
| Interest and fees on loans (tax equivalent basis) | \$ 7,713 | \$ 7,894 |
| Total interest income | \$ 9,597 | \$ 9,208 |
| Total interest expense | 3,438 | 3,800 |
| Net interest income | 6,159 | 5,408 |
| Total tax equivalent adjustment | 480 | 414 |
| Net interest income (tax equivalent basis) | \$ 6,639 | \$ 5,822 |

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

| | Change in Volume | 2009 vs. 2008 (1) Change in Rate | Total Change |
|---|---------------------|--|-----------------|
| Interest Income: | | | |
| Short-term investments: | | | |
| Interest-bearing deposits at banks | \$ 2 | \$ - | \$ 2 |
| Investment securities: | | | |
| Taxable | 455 | (25) | 430 |
| Tax-exempt | 185 | 19 | 204 |
| Total investments | 640 | (6) | 634 |
| Loans: | | | |
| Residential mortgage loans | (155) | (45) | (200) |
| Commercial & farm loans | 192 | (161) | 31 |
| Loans to state & political subdivisions | 28 | (5) | 23 |
| Other loans | (29) | (6) | (35) |
| Total loans, net of discount | 36 | (217) | (181) |
| Total Interest Income | 678 | (223) | 455 |
| Interest Expense: | | | |
| Interest-bearing deposits: | | | |
| NOW accounts | 79 | (225) | (146) |
| Savings accounts | 4 | (3) | 1 |
| Money Market accounts | (35) | (157) | (192) |
| Certificates of deposit | 539 | (230) | 309 |
| Total interest-bearing deposits | 587 | (615) | (28) |
| Other borrowed funds | (243) | (91) | (334) |
| Total interest expense | 344 | (706) | (362) |
| Net interest income | \$ 334 | \$ 483 | \$ 817 |

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

Tax equivalent net interest income rose from \$5,822,000 in 2008 to \$6,639,000 in 2009, an increase of \$817,000 for the three months ended March 31, 2009. The tax equivalent net interest margin improved from 4.24% for the first three months of 2008 to 4.34% in 2009.

Total interest income increased \$455,000. Of this, \$678,000 was due to volume as the average balance of interest earning assets increased by \$67.0 million. There was a decrease of \$223,000 due to change in rate, as the yield on interest earning assets decreased 41 basis points from 7.00% to 6.59%. Investment income for the three months ended March 31, 2009 increased \$634,000 over the same period last year. Total investment securities increased by \$47.6 million since last year due to investment opportunities including higher yields with a minimal impact on the overall duration of our portfolio. Taxable securities increased by \$36.0 million while tax-exempt securities increased by \$11.6 million, which had the effect of increasing interest income by \$455,000 and \$185,000, respectively, due to volume. The purchase of tax-exempt securities, along with municipal loans, allows us to manage our effective tax rate as well as the overall yield on our interest earning assets.

Total loan interest income decreased \$181,000 for the three months ended March 31, 2009 compared to the same period last year. Interest income on residential mortgage loans decreased \$200,000 of which \$155,000 was due to volume and \$45,000 due to a decrease in rate. The current economic recession, higher unemployment rates and other negative economic factors have resulted in lower loan demand for non-conforming residential mortgages and home equity loans. Loan demand for conforming mortgages, which the Company sells on the secondary market, has increased primarily due to lower interest rates. The average balance of commercial and farm loans increased \$16.7 million from a year ago primarily due to our emphasis and ability to grow this segment of the loan portfolio. This had a positive impact of \$192,000 on total interest income due to volume. Offsetting this, a decrease of 62 basis points earned on commercial and farm loans had the effect of decreasing interest income by \$161,000.

Total interest expense decreased \$362,000 for the three months ended March 31, 2009 compared with last year. Of this, a change in rate accounted for a \$706,000 decrease in our interest expense. The average interest rate on interest-bearing liabilities decreased 60 basis points, from 3.13% to 2.53%. The actions of the Federal Reserve and current economic downturn 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, the average balance of interest-bearing liabilities increased \$64.1 million resulting in an increase in interest expense of \$344,000 (see also "Financial Condition – Deposits"). The average balance of certificates of deposit increased \$72.6 million causing an increase in interest expense of \$539,000. The average balance of NOW accounts also increased \$16.5 million accounting for an increase of \$79,000 in interest expense. The average balance of borrowed funds decreased by \$25.1 million, which resulted in a decrease in interest expense of \$243,000 due to volume.

Provision For Loan Losses

For the three-month period ending March 31, 2009, we recorded \$150,000 to the provision as a result of our quarterly review of the allowance for loan losses. The provision was increased by \$30,000 over the same time period in 2008. 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, 2009 totaled \$1,354,000, an increase of \$145,000 when compared to the same period in 2008. Service charge income increased by \$36,000 and continues to be the Company's primary source of non-interest income. For the first three months of 2009, account service charges totaled \$812,000 compared to \$776,000 last year. Approximately \$12,000 of the increase is attributable to customers' usage of their debit cards and an additional \$11,000 is due to an increase in fees charged to customers for non-sufficient funds.

Brokerage and insurance income increased \$56,000 as we continue to increase the principal amounts invested through us by our customers. The hiring of an experienced broker has also had a positive impact on this increase in income. We continue to grow and develop this segment of business with our customers.

During the first quarter of 2009, investment securities gains amounted to \$16,000 compared to \$0 last year. We sold an agency bond at a gain that was likely to be called later this year. This was offset with a loss on the sale of bank equity shares. Earnings on bank owned life insurance increased by \$36,000 compared to last year primarily due to an additional investment in bank owned life insurance of approximately \$3.4 million in December 2008 based upon an analysis of new employees and updated future employee benefit costs.

The following table shows the breakdown of non-interest income for the three months ended March 31, 2009 and 2008:

| (dollars in thousands) | Three months ended | | Change | |
|---------------------------------------|--------------------|----------|--------|-------|
| | 2009 | 2008 | Amount | % |
| Service charges | \$ 812 | \$ 776 | \$ 36 | 4.6 |
| Trust | 163 | 167 | (4) | (2.4) |
| Brokerage and insurance | 100 | 44 | 56 | 127.3 |
| Investment securities gains, net | 16 | - | 16 | n/a |
| Earnings on bank owned life insurance | 121 | 85 | 36 | 42.4 |
| Other | 142 | 137 | 5 | 3.6 |
| Total | \$ 1,354 | \$ 1,209 | \$ 145 | 12.0 |

Non-interest Expense

Non-interest expenses increased \$457,000 or 11.7%, for the first three months of 2009, compared to the same period in 2008. The increase in salaries and employee benefits of \$140,000 is due mainly to annual merit increases and increases in incentive pay accruals.

Other expense increased by \$383,000 primarily due to an increase in our FDIC deposit insurance assessments. Through the first three months of this year, we have expensed \$375,000 for FDIC assessments compared to only \$13,000 last year. In 2008 we recognized approximately \$209,000 in credits as a result of the Federal Deposit Insurance Reform Act of 2005. Credits related to this legislation were fully utilized by the end of 2008. Due to the recent strain on the FDIC deposit insurance fund, the FDIC has proposed an additional, special assessment of up to 20 basis points on all financial institutions. As such, we anticipate even higher premiums in the second quarter.

Professional fees decreased \$50,000 due to non-recurring costs in 2008 surrounding branch expansion activities. The \$23,000 decrease in furniture and equipment is due to assets becoming fully depreciated.

The following tables reflect the breakdown of non-interest expense and professional fees as of March 31, 2009 and 2008:

| (in thousands) | Three months ended | | Change | |
|--------------------------------|--------------------|----------|--------|--------|
| | 2009 | 2008 | Amount | % |
| Salaries and employee benefits | \$ 2,296 | \$ 2,156 | \$ 140 | 6.5 |
| Occupancy | 321 | 314 | 7 | 2.2 |
| Furniture and equipment | 110 | 133 | (23) | (17.3) |
| Professional fees | 131 | 181 | (50) | (27.6) |
| Other | 1,514 | 1,131 | 383 | 33.9 |
| Total | \$ 4,372 | \$ 3,915 | \$ 457 | 11.7 |

| (in thousands) | Three months ended | | Change | |
|-------------------------|--------------------|--------|---------|--------|
| | 2009 | 2008 | Amount | % |
| Other professional fees | \$ 72 | \$ 99 | \$ (27) | (27.3) |
| Legal fees | 8 | 27 | (19) | (70.4) |
| Examinations and audits | 51 | 55 | (4) | (7.3) |
| Total | \$ 131 | \$ 181 | \$ (50) | (27.6) |

Provision For Income Taxes

The provision for income taxes was \$645,000 for the three-month period ended March 31, 2009 compared to \$561,000 for the same period in 2008. The increase is attributable primarily due to an increase in taxable income of \$409,000 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% and 21.7% for the first three months of 2009 and 2008, respectively, compared to the statutory rate of 34%.

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 \$776,000 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 \$279,000 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 \$129,000 out of a total \$574,000 of tax credits. We anticipate recognizing \$688,000 of tax credits over the next eight years.

Financial Condition

Total assets were \$674.7 million at March 31, 2009, an increase of \$6.1 million from \$668.6 million at December 31, 2008. Net loans increased 1.1% to \$437.6 million and investment securities decreased slightly to \$173.8 million at March 31, 2009. Total deposits increased \$7.9 million or 1.4% to \$554.6 million since year-end 2008. Borrowed funds have decreased \$4.4 million to \$56.8 million compared with \$61.2 million at year-end.

Cash and Cash Equivalents

Cash and cash equivalents totaled \$21.7 million at March 31, 2009 compared to \$19.9 million at December 31, 2008. Non-interest-bearing cash increased \$985,000 since year-end 2008, while interest-bearing cash also increased \$857,000 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 decreased by \$327,000 or .2% from December 31, 2008 to March 31, 2009. During the first quarter of 2009 we purchased approximately \$10.8 million of U.S. agency obligations and \$1.6 million of state and local obligations which offset the \$6.6 million of principal repayments and \$4.2 million of calls that occurred during the quarter. We also selectively sold \$2.2 million of bonds and equities at a net gain of \$16,000. The overall market value of our investment portfolio increased approximately \$.3 million due to market fluctuations since year end. Our investment portfolio is currently yielding 5.40% compared to 5.42% a year ago on a tax equivalent basis.

| (dollars in thousands) | Estimated Fair Market Value of Investment Portfolio | | | |
|---|---|------|-------------------|------|
| | March 31, 2009 | | December 31, 2008 | |
| | Amount | % | Amount | % |
| Available-for-sale: | | | | |
| U. S. Agency securities | \$ 33,571 | 19.3 | \$ 28,942 | 16.6 |
| Obligations of state & political subdivisions | 45,335 | 26.1 | 44,132 | 25.3 |
| Corporate obligations | 4,979 | 2.9 | 5,296 | 3.0 |

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| | | | | |
|----------------------------|------------|-------|------------|-------|
| Mortgage-backed securities | 89,670 | 51.6 | 95,407 | 54.8 |
| Equity securities | 257 | 0.1 | 362 | 0.3 |
| Total | \$ 173,812 | 100.0 | \$ 174,139 | 100.0 |

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| (dollars in thousands) | March 31, 2009/ December 31, 2008 | |
|-------------------------------------|--------------------------------------|-------------|
| | Amount | Change % |
| Available-for-sale: | | |
| U. S. Agency securities | \$ 4,629 | 16.0 |
| Obligations of state & political | | |
| subdivisions | 1,203 | 2.7 |
| Corporate obligations | (317) | (6.0) |
| Mortgage-backed securities | (5,737) | (6.0) |
| Equity securities | (105) | (29.0) |
| Total | \$ (327) | (0.2) |

Management continues to monitor the earnings performance and the liquidity of the investment portfolio on a regular basis. Through active balance sheet management and analysis of the securities portfolio, the Company believes it 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 \$4.8 million or 1.1% during the first quarter of 2009. Commercial real estate, agricultural, and commercial and other loans increased \$9.1 million, \$.2 million, and \$3.9 million, respectively. Residential real estate, construction, consumer, and municipal loans have decreased \$2.3 million, \$3.2 million, \$.2 million and \$2.7 million, respectively.

There has been a decrease in loan demand for residential real estate, construction and consumer loans due to several economic factors. Recessionary pressures and a depressed housing market have had a negative impact on nonconforming, residential real estate mortgage and home equity loan growth. Loan demand for conforming mortgages, which the Company sells on the secondary market, has increased during the first quarter. Despite the slight run-off in the first quarter, residential mortgage lending is a principal business activity and our Company continues to offer a variety of competitively priced conforming, nonconforming and home equity mortgages.

The growth in commercial real estate, agricultural and other commercial loans, despite the slowing economy, reflects 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.

| (in thousands) | March 31, 2009 | | December 31, 2008 | |
|----------------|-------------------|------|----------------------|------|
| | Amount | % | Amount | % |
| Real estate: | | | | |
| Residential | \$ 196,860 | 45.0 | \$ 199,118 | 46.0 |

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| | | | | |
|---|-------------------|--------------|-------------------|--------------|
| Commercial | 116,801 | 26.7 | 107,740 | 24.9 |
| Agricultural | 17,223 | 3.9 | 17,066 | 3.9 |
| Construction | 7,935 | 1.8 | 11,118 | 2.6 |
| Loans to individuals | | | | |
| for household, family and other purchases | 11,414 | 2.6 | 11,651 | 2.7 |
| Commercial and other loans | 41,912 | 9.6 | 37,968 | 8.8 |
| State & political subdivision loans | 45,433 | 10.4 | 48,153 | 11.1 |
| Total loans | 437,578 | 100.0 | 432,814 | 100.0 |
| Less allowance for loan losses | 4,498 | | 4,378 | |
| Net loans | \$ 433,080 | | \$ 428,436 | |

| (in thousands) | March 31, 2009/ December 31, 2008 Change | |
|--|---|--------|
| | Amount | % |
| Real estate: | | |
| Residential | \$ (2,258) | (1.1) |
| Commercial | 9,061 | 8.4 |
| Agricultural | 157 | 0.9 |
| Construction | (3,183) | (28.6) |
| Loans to individuals | | |
| for household, family and other purchases | (237) | (2.0) |
| Commercial and other loans | 3,944 | 10.4 |
| State & political subdivision loans | (2,720) | (5.6) |
| Total loans | \$ 4,764 | 1.1 |

Allowance For Loan Losses

The allowance for loan losses as a percentage of loans increased from 1.01% at December 31, 2008 to 1.03% at March 31, 2009. The dollar amount of the reserve increased \$120,000 since year-end 2008. The increase is a result of a \$150,000 provision for the first quarter less net charge-offs. Gross charge-offs for the first three months of 2009 were \$51,000, while recoveries were \$21,000.

| (in thousands) | March 31, | | December 31, | | |
|---|-----------|----------|--------------|----------|----------|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| Balance, at beginning of period | \$ 4,378 | \$ 4,197 | \$ 3,876 | \$ 3,664 | \$ 3,919 |
| Provision charged to income | 150 | 330 | 365 | 330 | 60 |
| Increase related to acquisition | - | - | - | - | - |
| Recoveries on loans previously charged against the allowance | 21 | 97 | 142 | 172 | 57 |
| | 4,549 | 4,624 | 4,383 | 4,166 | 4,036 |
| Loans charged against the allowance | (51) | (246) | (186) | (290) | (372) |
| Balance, at end of year | \$ 4,498 | \$ 4,378 | \$ 4,197 | \$ 3,876 | \$ 3,664 |
| Allowance for loan losses as a percent | | | | | |
| of total loans | 1.03% | 1.01% | 0.99% | 0.93% | 0.96% |
| Allowance for loan losses as a percent | | | | | |
| of non-performing loans | 199.20% | 169.36% | 191.64% | 115.43% | 163.94% |

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, 2009. The Company has disclosed in its annual report on Form 10-K for the year ended December 31, 2008 the process and methodology supporting the loan loss provision.

Credit Quality Risk

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

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| (dollars in thousands) | March 31, 2009 | 2008 | December 31, 2007 | 2006 | 2005 |
|---|-------------------|---------|----------------------|---------|---------|
| Non-performing loans: | | | | | |
| Non-accruing loans | \$ 448 | \$ 580 | \$ 827 | \$ 478 | \$ 867 |
| Impaired loans | 1,390 | 1,622 | 1,088 | 1,190 | 1,031 |
| Accrual loans - 90 days or more past due | 420 | 383 | 275 | 1,690 | 337 |
| Total non-performing loans | 2,258 | 2,585 | 2,190 | 3,358 | 2,235 |
| Foreclosed assets held for sale | 648 | 591 | 203 | 758 | 619 |
| Total non-performing assets | \$ 2,906 | \$3,176 | \$2,393 | \$4,116 | \$2,854 |
| Non-performing loans as a percent of loans net of unearned income | 0.52% | 0.60% | 0.52% | 0.81% | 0.58% |
| Non-performing assets as a percent of loans net of unearned income | 0.66% | 0.73% | 0.57% | 0.99% | 0.75% |

Interest does not accrue on non-accrual loans. Subsequent cash payments received are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of its ultimate ability to collect principal and interest. Overall, the credit quality of our loans remains strong and non-performing assets compare positively to past periods.

Bank Owned Life Insurance

The Company has elected to purchase bank owned life insurance to offset future employee benefit costs. As of March 31, 2009 the cash surrender value of this life insurance is \$12,296,000, an increase of \$120,000 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.

Premises and Equipment

Premises and equipment decreased \$1,131,000 from \$12,762,000 at December 31, 2008 to \$11,631,000 at March 31, 2009, a decrease of 8.9%. This occurred primarily due to the sale of a banking facility for approximately \$1.5 million during the first quarter. We continue to lease and conduct business at the property. Offsetting this decrease were purchases of premises and equipment in the amount of \$433,000 primarily due to bank construction at our Troy, Pennsylvania location.

Deposits

Core deposits continue to be the most significant source of funds for the Company. Deposits increased \$7,896,000 or 1.4%, since December 31, 2008. The increase in deposits is due to several reasons. Our market area has been positively impacted by oil and gas exploration activities. We have developed targeted products to meet the needs of customers benefiting from this activity. The overall turbulence and volatility in the financial markets has resulted in customers seeking more stability in their deposits. Finally, our ability to work with local municipalities to meet their business needs has resulted in increased deposits.

As of March 31, 2009, non-interest-bearing deposits and savings accounts increased \$973,000 and \$777,000, respectively, from December 31, 2008, and certificates of deposit increased by \$8,209,000. The increase in certificates of deposit is primarily due to customers shifting balances from lower paying deposit accounts into CD's in order to increase their return. As mentioned, oil and gas exploration has had a positive impact on this segment as

well. NOW accounts had a small decrease of \$726,000 and money market deposits decreased \$1,337,000 due to customers seeking higher rates of return. The Bank currently does not have any outstanding brokered certificates of deposit.

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| (in thousands) | March 31, 2009 | | December 31, 2008 | |
|-------------------------------|-------------------|-------|----------------------|-------|
| | Amount | % | Amount | % |
| Non-interest-bearing deposits | \$ 56,518 | 10.2 | \$ 55,545 | 10.2 |
| NOW accounts | 114,612 | 20.6 | 115,338 | 21.1 |
| Savings deposits | 45,224 | 8.2 | 44,447 | 8.1 |
| Money market deposit accounts | 40,415 | 7.3 | 41,752 | 7.6 |
| Certificates of deposit | 297,807 | 53.7 | 289,598 | 53.0 |
| Total | \$ 554,576 | 100.0 | \$ 546,680 | 100.0 |

| (in thousands) | March 31, 2009/ December 31, 2008 Change | |
|-------------------------------|--|-------|
| | Amount | % |
| Non-interest-bearing deposits | \$ 973 | 1.8 |
| NOW accounts | (726) | (0.6) |
| Savings deposits | 777 | 1.7 |
| Money market deposit accounts | (1,337) | (3.2) |
| Certificates of deposit | 8,209 | 2.8 |
| Total | \$ 7,896 | 1.4 |

Borrowed Funds

Borrowed funds decreased \$4,440,000 during the first three months of 2009. The ability to grow deposits decreased our reliance on borrowed funds. The Company's daily cash requirements or short-term investments are primarily met by using the financial instruments available primarily through the Federal Home Loan Bank.

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

In December, 2008, the Company entered into an interest rate swap agreement to convert floating-rate debt to fixed rate debt on a notional amount of \$7.5 million. The interest rate swap instrument involves an agreement to receive a floating rate and pay a fixed rate, at specified intervals, calculated on the agreed-upon notional amount. The differentials paid or received on interest rate swap agreements are recognized as adjustments to interest expense in the period. The interest rate swap agreement was entered into on December 17, 2008 and expires December 17, 2013. The fair value of the interest rate swap at March 31, 2009 was a liability of \$330,000 and is included within other liabilities on the consolidated balance sheets.

Stockholder's Equity

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

Total stockholders' equity was \$54,439,000 at March 31, 2009 compared to \$52,770,000, at December 31, 2008, an increase of \$1,669,000 or 3.2%. Excluding accumulated other comprehensive income, stockholder's equity increased \$1,492,000, or 2.8%. In the first three months of 2009, the Company had net income of \$2,346,000 and paid dividends of \$683,000, representing a dividend payout ratio of 29.11%. The Company purchased 9,595 shares of treasury stock at a weighted average cost of \$19.52 per share. The Company also awarded 7,526 shares of restricted stock to employees and 900 shares to the Board of Directors for incentive programs.

All of the Company's investment securities are classified as available-for-sale, making this portion of the Company's balance sheet more sensitive to the changing market value of investments. Accumulated other comprehensive income increased \$177,000 from December 31, 2008 as a result of market value fluctuations.

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

| (dollars in thousands) | March 31, 2009 | | December 31, 2008 | |
|--|-------------------|--------|----------------------|--------|
| | Amount | Ratio | Amount | Ratio |
| Total capital (to risk-weighted assets) | | | | |
| Company | \$56,681 | 13.17% | \$54,924 | 13.06% |
| For capital adequacy purposes | 34,421 | 8.00% | 33,652 | 8.00% |
| To be well capitalized | 43,026 | 10.00% | 42,065 | 10.00% |
| Tier I capital (to risk-weighted assets) | | | | |
| Company | \$52,183 | 12.13% | \$50,546 | 12.02% |
| For capital adequacy purposes | 17,210 | 4.00% | 16,826 | 4.00% |
| To be well capitalized | 25,816 | 6.00% | 25,239 | 6.00% |
| Tier I capital (to average assets) | | | | |
| Company | \$52,183 | 7.93% | \$50,546 | 7.91% |
| For capital adequacy purposes | 26,315 | 4.00% | 25,547 | 4.00% |
| To be well capitalized | 32,894 | 5.00% | 31,934 | 5.00% |

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

| (dollars in thousands) | March 31, 2009 | | December 31, 2008 | |
|--|-------------------|--------|----------------------|--------|
| | Amount | Ratio | Amount | Ratio |
| Total capital (to risk-weighted assets) | | | | |
| Bank | \$51,176 | 11.92% | \$49,248 | 11.73% |
| For capital adequacy purposes | 34,360 | 8.00% | 33,593 | 8.00% |
| To be well capitalized | 42,950 | 10.00% | 41,991 | 10.00% |
| Tier I capital (to risk-weighted assets) | | | | |
| Bank | \$46,678 | 10.87% | \$44,871 | 10.69% |
| For capital adequacy purposes | 17,180 | 4.00% | 16,796 | 4.00% |
| To be well capitalized | 25,770 | 6.00% | 25,194 | 6.00% |
| Tier I capital (to average assets) | | | | |
| Bank | \$46,678 | 7.11% | \$44,871 | 7.04% |

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| | | | | |
|-------------------------------|--------|-------|--------|-------|
| For capital adequacy purposes | 26,278 | 4.00% | 25,510 | 4.00% |
| To be well capitalized | 32,847 | 5.00% | 31,887 | 5.00% |

Off Balance Sheet Activities

Some financial instruments, such as loan commitments, credit lines, and letters of credit are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at March 31, 2009 (dollars in thousands):

| | |
|-------------|---------|
| Commitments | |
| to extend | \$ |
| credit | 100,306 |
| Standby | |
| letters of | |
| credit | 6,208 |
| | \$ |
| | 106,514 |

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing for business, personal or household use. The non-contractual amount of financial instruments with off-balance sheet risk at March 31, 2009 was \$11,552,000. The Company reserves the right to discontinue this service without prior notice.

Liquidity

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

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

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other significant uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures during the first three months of 2009 were \$433,000, compared to \$50,000 during the same time period in 2008. Surplus funds are invested in investment securities.

Short-term debt from the FHLB supplements the Company's availability of funds. The Company achieves liquidity primarily from temporary or short-term investments in the FHLB. The Company has a maximum borrowing capacity at the FHLB of approximately \$277.6 million, of which \$40.2 million was outstanding at March 31, 2009. Additionally, we have a Federal funds line that consists of a \$12.0 million unsecured credit line from a third party bank at market rates. The Company also has another \$10.0 million line of credit through a third party provider that is renewable annually.

Interest Rate and Market Risk Management

The objective of interest rate sensitivity management is to maintain an appropriate balance between the stable growth of income and the risks associated with maximizing income through interest sensitivity imbalances and the market value risk of assets and liabilities.

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk and, since our Company has no trading portfolio, it is not subject to trading risk.

Currently, our Company has equity securities that represent only .1% of our investment portfolio and, therefore, equity risk is not significant.

The primary components of interest-sensitive assets include adjustable-rate loans and investments, loan repayments, investment maturities and money market investments. The primary components of interest-sensitive liabilities include maturing certificates of deposit, IRA certificates of deposit and short-term borrowings. Savings deposits, NOW accounts and money market investor accounts are considered core deposits and are not short-term interest sensitive (except for the top-tier money market investor accounts which are paid current market interest rates).

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

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

We use numerous interest rate simulations employing a variety of assumptions to evaluate our interest rate risk exposure. A shock analysis during the first quarter of 2009 indicated that a 200 basis point movement in interest rates in either direction would have a minor impact on our Company's anticipated net interest income over the next twenty-four months.

Item 3-Quantitative and Qualitative Disclosure About Market Risk

In the normal course of conducting business activities, the Company is exposed to market risk, principally interest rate risk, through the operations of its banking subsidiary. Interest rate risk arises from market driven fluctuations in interest rates that affect cash flows, income, expense and values of financial instruments and was discussed previously in this Form 10-Q. Management and a committee of the Board of Directors manage interest rate risk (see also "Interest Rate and Market Risk Management").

No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the SEC Form 10-K for the period ended December 31, 2008.

Item 4-Control and Procedures

(a) Disclosure Controls and Procedures

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

(b) Changes to Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended March 31, 2009 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

Management is not aware of any litigation that would have a material adverse effect on the consolidated financial position of the Company. Any pending proceedings are ordinary, routine litigation incidental to the business of the Company and its subsidiary. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Company and its subsidiary by government authorities.

Item 1A – Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1.A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2008, which could materially affect our business, financial condition or future results. At March 31, 2009 the risk factors of the Company have not changed materially from those reported in our Annual Report on Form 10-K. However, the risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares (or units Purchased) | Average Price Paid per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1) |
|-------------------|---|--|---|---|
| 1/1/09 to 1/31/09 | - | \$0.00 | - | 64,300 |
| 2/1/09 to 2/29/09 | 5,595 | \$19.35 | 5,595 | 58,705 |
| 3/1/09 to 3/31/09 | 4,000 | \$19.75 | 4,000 | 54,705 |
| Total | 9,595 | \$19.52 | 9,595 | 54,705 |

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

Item 3 - Defaults Upon Senior Securities

Not applicable.

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

None

Item 5 - Other Information

None

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Item 6 - Exhibits

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

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

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

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

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

Signatures

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

Citizens Financial Services, Inc.

May 11, 2009

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

May 11, 2009

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

