CITIZENS FINANCIAL SERVICES INC
Form 10-Q
August 09, 2007

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

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

For the quarterly period ended June 30, 2007

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 __X__ No_____

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

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

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

The number of shares outstanding of the Registrant's Common Stock, as of July 30, 2007, was 2,840,398 of Common Stock, par value $1.00.

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

(in thousands except share data)	**June 30 2007**	December 31 2006
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	**$ 10,873**	$ 10,007
Interest-bearing	**12**	8
Total cash and cash equivalents	**10,885**	10,015
Available-for-sale securities	**118,614**	109,743
Loans (net of allowance for loan losses:		
2007, $4,107 and 2006, $3,876)	**410,967**	410,897
Premises and equipment	**12,660**	12,892
Accrued interest receivable	**2,383**	2,458
Goodwill	**8,605**	8,605
Bank owned life insurance	**8,209**	8,047
Other assets	**8,958**	9,511
TOTAL ASSETS	**$ 581,281**	$ 572,168
LIABILITIES:		
Deposits:		
Noninterest-bearing	**$ 50,753**	$ 48,509
Interest-bearing	**417,189**	398,006
Total deposits	**467,942**	446,515
Borrowed funds	**62,382**	75,775
Accrued interest payable	**2,086**	2,287
Other liabilities	**4,531**	4,091
TOTAL LIABILITIES	**536,941**	528,668
STOCKHOLDERS' EQUITY:		
Common stock		
$1.00 par value; authorized 10,000,000 shares;		
issued 2,992,896 shares in 2007 and 2006, respectively	**2,993**	2,993
Additional paid-in capital	**11,935**	11,933
Retained earnings	**35,892**	34,007
Accumulated other comprehensive loss	**(2,551)**	(1,737)
Unearned restricted stock: 3,074 shares for 2007 and 0 shares for 2006	**(72)**	-
Treasury stock, at cost: 180,140 shares for		
2007, and 172,954 shares for 2006	**(3,857)**	(3,696)
TOTAL STOCKHOLDERS' EQUITY	**44,340**	43,500
TOTAL LIABILITIES AND		
STOCKHOLDERS' EQUITY	**$ 581,281**	$ 572,168

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

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

(in thousands, except per share data)	Three Months Ended June 30, **2007**	Three Months Ended June 30, 2006	Six Months Ended June 30, **2007**	Six Months Ended June 30, 2006
INTEREST INCOME:				
Interest and fees on loans	**$ 7,539**	$ 6,894	**$ 14,896**	$ 13,413
Investment securities:				
Taxable	**1,057**	879	**2,071**	1,698
Nontaxable	**225**	221	**449**	447
Dividends	**78**	82	**169**	149
TOTAL INTEREST INCOME	**8,899**	8,076	**17,585**	15,707
INTEREST EXPENSE:				
Deposits	**3,430**	2,722	**6,740**	5,323
Borrowed funds	**806**	876	**1,732**	1,539
TOTAL INTEREST EXPENSE	**4,236**	3,598	**8,472**	6,862
NET INTEREST INCOME	**4,663**	4,478	**9,113**	8,845
Provision for loan losses	**45**	60	**165**	120
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**4,618**	4,418	**8,948**	8,725
NON-INTEREST INCOME:				
Service charges	**812**	809	**1,560**	1,515
Trust	**127**	108	**264**	237
Brokerage	**31**	59	**49**	153
Investment securities gains (losses), net	**-**	5	**-**	(1)
Gains on loans sold	**46**	7	**64**	13
Gains on sales of foreclosed properties	**373**	34	**396**	47
Earnings on bank owned life insurance	**82**	74	**162**	146
Other	**120**	95	**223**	213
TOTAL NON-INTEREST INCOME	**1,591**	1,191	**2,718**	2,323
NON-INTEREST EXPENSES:				
Salaries and employee benefits	**2,033**	1,987	**4,126**	4,023
Occupancy	**308**	276	**609**	584
Furniture and equipment	**140**	144	**268**	296
Professional fees	**155**	106	**320**	246
Amortization	**36**	36	**72**	180
Other	**1,284**	1,188	**2,338**	2,299
TOTAL NON-INTEREST EXPENSES	**3,956**	3,737	**7,733**	7,628
Income before provision for income taxes	**2,253**	1,872	**3,933**	3,420
Provision for income taxes	**493**	386	**793**	658
NET INCOME	**$ 1,760**	$ 1,486	**$ 3,140**	$ 2,762
Earnings Per Share	**$ 0.63**	$ 0.52	**$ 1.11**	$ 0.97
Cash Dividends Paid Per Share	**$ 0.225**	$ 0.215	**$ 0.445**	$ 0.425

Weighted average number of shares outstanding	**2,815,873**	2,847,259	**2,817,813**	2,857,554

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

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

(in thousands)	Three Months Ended June 30, **2007**	Three Months Ended June 30, 2006	Six Months Ended June 30, **2007**	Six Months Ended June 30, 2006
Net income	**$ 1,760**	$ 1,486	**$ 3,140**	$ 2,762
Other comprehensive income:				
Unrealized losses on available for sale securities	**(1,433)**	(624)	**(1,233)**	(1,239)
Less: Reclassification adjustment for gains (losses) included in net income	**-**	(5)	**-**	1
Other comprehensive loss before tax	**(1,433)**	(629)	**(1,233)**	(1,238)
Income tax benefit related to other comprehensive income	**(487)**	(214)	**(419)**	(421)
Other comprehensive loss, net of tax	**(946)**	(415)	**(814)**	(817)
Comprehensive income	**$ 814**	$ 1,071	**$ 2,326**	$ 1,945

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

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

(in thousands)	Six Months Ended June 30, **2007**	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 3,140**	$ 2,762
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**165**	120
Depreciation and amortization	**376**	646
Amortization and accretion of investment securities	**93**	238
Deferred income taxes	**(12)**	(59)
Investment securities gains, net	**-**	1
Realized gains on loans sold	**(64)**	(13)
Earnings on bank owned life insurance	**(162)**	(146)
Losses on premises and equipment	**100**	1
Originations of loans held for sale	**(3,198)**	(1,172)
Proceeds from sales of loans held for sale	**3,262**	1,185
Gains on sale of foreclosed assets held for sale	**(396)**	(47)
Decrease in accrued interest receivable	**75**	55
Decrease in accrued interest payable	**(201)**	(123)
Other, net	**339**	(107)
Net cash provided by operating activities	**3,517**	3,341
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from sales of available-for-sale securities	**-**	9,791
Proceeds from maturity and principal repayments of securities	**5,848**	8,130
Purchase of securities	**(16,045)**	(19,411)
Proceeds from redemption of Regulatory Stock	**1,395**	889
Purchase of Regulatory Stock	**(965)**	(1,788)
Net increase in loans	**(229)**	(19,186)
Purchase of premises and equipment	**(273)**	(269)
Proceeds from sale of foreclosed assets held for sale	**1,075**	256
Net cash used in investing activities	**(9,194)**	(21,588)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	**21,426**	8,110
Proceeds from long-term borrowings	**6,638**	2,444
Repayments of long-term borrowings	**(3,500)**	(4,339)
Net increase (decrease) in short-term borrowed funds	**(16,531)**	16,336
Purchase of Treasury Stock	**(244)**	(778)
Reissuance of Treasury Stock	**13**	-
Dividends paid	**(1,255)**	(1,204)
Net cash provided by financing activities	**6,547**	20,569
Net increase in cash and cash equivalents	**870**	2,322
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	**10,015**	8,609

CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$**	**10,885**	$	10,931
Supplemental Disclosures of Cash Flow Information:				
Interest paid	**$**	**8,673**	$	6,679
Income taxes paid	**$**	**410**	$	770
Loans transferred to foreclosed property	**$**	**61**	$	375

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 Service, 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 its subsidiary, First Citizens Insurance Agency, Inc. All material inter-company balances and transactions have been eliminated in consolidation.

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

In the opinion of Management of the registrant, the accompanying interim financial statements for the quarters ended June 30, 2007 and 2006 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the period. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. The financial performance reported for the Company for the six-month period ended June 30, 2007 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Company's Annual Report to shareholders and Form 10-K for the period ended December 31, 2006.

Note 2 - Earnings per Share

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

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	**2007**	2006
Net income applicable to common stock	**$1,760,000**	$1,486,000	**$3,140,000**	$2,762,000
Weighted average common shares outstanding	**2,815,873**	2,847,259	**2,817,813**	2,857,554
Earnings per share	**$0.63**	$0.52	**$1.11**	$0.97

Note 3 - Income Tax Expense

Income tax expense is less than the amount calculated using the statutory tax rate, primarily the result of tax-exempt income earned from state and municipal securities, bank owned life insurance, 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 2006 Annual Report on Form 10-K.

Defined Benefit Plan

The following sets forth the components of net periodic benefit costs of the noncontributory defined benefit plan for the three months and six months ended June 30, 2007 and 2006, respectively (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	**2007**	2006
Service cost	**$ 105**	$ 87	**$ 222**	$ 178
Interest cost	**102**	84	**214**	166
Expected return on plan assets	**(117)**	(86)	**(246)**	(181)
Net amortization and deferral	**18**	25	**38**	40
Net periodic benefit cost	**$ 108**	$ 110	**$ 228**	$ 203

The Company expects to contribute $370,029 to its noncontributory defined benefit pension plan in 2007. As of June 30, 2007, the Company has contributed $112,635.

Defined Contribution Plan

The Company also sponsors a defined contribution, 401(k) plan covering substantially all of its employees. The Company contributes three percent of applicable salaries into the plan. Contributions totaled $98,000 and $99,000 for the six months ended June 30, 2007 and 2006, respectively.

Note 5 – Recent Accounting Pronouncements

In February 2007, the FASB issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115, which provides all entities with an option to report selected financial assets and liabilities at fair value. The objective of the FAS No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in earnings caused by measuring related assets and liabilities differently without having to apply the complex provisions of hedge accounting. FAS No. 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided the entity also elects to apply the provisions of FAS No. 157, Fair Value Measurements. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In March 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-10 ("EITF 06-10"), *Accounting for Collateral Assignment Split-Dollar Life Insurance Agreements*. EITF 06-10 provides guidance for determining a liability for the postretirement benefit obligation as well as recognition and measurement of the associated asset on the basis of the terms of the collateral assignment agreement. EITF 06-10 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact the adoption of the EITF will have on the Company's results of operations or financial condition.

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 the EITF will have on the Company’s financial condition.

Note 6 – Comprehensive Income

For the three and six month periods ended June 30, 2007 and 2006, the components of other comprehensive income and total comprehensive income are presented in the Consolidated Statement of Comprehensive Income. We had previously reported in our 2006 annual report to shareholders total comprehensive income for the year ended December 31, 2006 of $5,603, which consisted of net income, the change in net unrealized loss of securities available for sale, net of taxes, and the cumulative effect of change in accounting for pension obligation, net of tax benefit of $5,800, $655, and $(852), respectively. The cumulative effect of change in accounting for pension obligations upon the initial adoption of Financial Accounting Standards Board Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, is required to be reported separately in accumulated other comprehensive income and not as part of comprehensive income for the period. As such, we are revising our previously reported total comprehensive income to $6,689 for the year ended December 31, 2006. The only other revision to the components of other comprehensive income consists of a reversal of a previously recognized minimum pension liability of $234, which is net of taxes of $121. These revisions were also necessary to reflect the revised cumulative effect of change in accounting for pension obligation of $(1,086), which is net of a tax benefit of $560 as of December 31, 2006.

The Company intends to correct the Other Comprehensive Income presentation in its next Form 10-K filing.

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

Cautionary Statement

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

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

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 Citizens Financial Service, Inc., a bank holding company and its subsidiary (the Company). Our Company's consolidated financial condition and results of operations consist almost entirely of our wholly owned subsidiary’s (First Citizens National Bank) financial conditions and results of operations. Management’s discussion and analysis should be read in conjunction with the preceding June 30, 2007 financial information. The results of operations for the three months and six months ended June 30, 2007 and 2006 are not necessarily indicative of the results you may expect for the full year.

Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 16 banking facilities. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, the Wellsboro Weis Market store, and the Mansfield Wal-Mart Super Center. In New York, we have 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, 2006, 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. We also help the members of our communities prepare for retirement by providing retirement plans for local employers and by managing individual IRA accounts. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Company. As of June 30, 2007 and December 31, 2006, the Trust Department had $91.5 million and $82.6 million of assets under management, respectively.

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

Results of Operations

Overview of the Income Statement

The Company had net income of $3,140,000 for the first six months of 2007 compared with earnings of $2,762,000 for last year's comparable period, an increase of $378,000 or 13.7%. Earnings per share for the first six months of 2007 were $1.11, compared to $.97 last year representing a 14.4% increase. Annualized return on assets and return on equity for the six months of 2007 was 1.10% and 13.68%, respectively, compared with 1.02% and 12.75% for last year's comparable period.

Net income for the three months ended June 30, 2007 totaled $1,760,000 compared with $1,486,000 for the comparable period last year, an increase of $274,000 or 18.4%. Earnings per share for the three months ended June 30, 2007 and 2006 were $.63 and $.52 per share, respectively. Annualized return on assets and return on equity for the quarter ended June 30, 2007 was 1.23% and 15.24%, respectively, compared with 1.09% and 13.55% for last year's comparable period.

Details of the reasons for this change are discussed on the following pages.

Net Interest Income

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

Net interest income, for the first half of 2007, was $9,113,000, an increase of $268,000 compared to the same period in 2006. For the first six months of 2007, the provision for loan losses totaled $165,000 compared to $120,000 for the first six months of 2006. Consequently, net interest income after the provision for loan losses was $8,948,000, an increase of $223,000 over the first six months of 2006.

For the three months ended June 30, 2007, net interest income was $4,663,000, which was $185,000 or 4.1% higher than the comparable period last year. The provision for loan losses was $45,000 for the three months ended June 30, 2007 compared with $60,000 the same period last year. As such, net interest income after the provision for loan losses was $4,618,000 compared with $4,418,000 for the quarters ended June 30, 2007 and 2006, respectively.

The following table sets forth the average balances of, and the interest earned or incurred on, each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and rate "spread" created for the six months ended June 30, 2007, 2006 and 2005:

Analysis of Average Balances and Interest Rates (1)

	Six Months Ended June 30, 2007			Six Months Ended June 30, 2006			Six Months Ended June 30, 2005		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%	$	$	%
ASSETS									
Short-term investments:									
Interest-bearing deposits at banks	**3**	**-**	-	5	-	-	30	-	0.01
Total short-term investments	**3**	**-**	**-**	5	-	-	30	-	0.01
Investment securities:									
Taxable	**93,630**	**2,260**	**4.83**	85,976	1,872	4.35	87,232	1,670	3.83
Tax-exempt (3)	**22,607**	**680**	**6.02**	22,500	677	6.02	11,643	366	6.29
Total investment securities	**116,237**	**2,940**	**5.06**	108,476	2,549	4.70	98,875	2,036	4.12
Loans:									
Residential mortgage loans	**211,803**	**7,737**	**7.37**	204,995	7,083	6.97	198,403	6,728	6.84
Commercial & farm loans	**145,762**	**5,692**	**7.87**	130,163	4,894	7.58	116,322	3,980	6.90
Loans to state & political subdivisions	**44,911**	**1,344**	**6.03**	43,289	1,283	5.98	38,704	1,150	5.99
Other loans	**12,135**	**555**	**9.22**	12,950	567	8.83	12,432	544	8.82
Loans, net of discount (2)(3)(4)	**414,611**	**15,328**	**7.46**	391,397	13,827	7.12	365,861	12,402	6.84
Total interest-earning assets	**530,851**	**18,268**	**6.94**	499,878	16,376	6.61	464,766	14,438	6.26
Cash and due from banks	**9,213**			8,770			8,529		
Bank premises and equipment	**12,904**			12,228			11,907		
Other assets	**19,007**			18,484			18,667		
Total non-interest earning assets	**41,124**			39,482			39,103		
Total assets	**571,975**			539,360			503,869		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									
NOW accounts	**89,466**	**925**	**2.08**	83,558	727	1.75	69,165	259	0.76
Savings accounts	**38,280**	**65**	**0.34**	39,509	62	0.32	40,652	57	0.28
Money market accounts	**48,562**	**877**	**3.64**	44,476	638	2.89	45,841	366	1.61
Certificates of deposit	**233,334**	**4,873**	**4.21**	210,391	3,896	3.73	213,729	3,742	3.53

Total interest-bearing deposits	**409,642**	**6,740**	**3.32**	377,934	5,323	2.84	369,387	4,424	2.42
Other borrowed funds	**62,656**	**1,732**	**5.57**	63,536	1,539	4.88	43,387	758	3.52
Total interest-bearing liabilities	**472,298**	**8,472**	**3.62**	441,470	6,862	3.13	412,774	5,182	2.53
Demand deposits	**48,458**			49,061			45,511		
Other liabilities	**6,413**			5,722			4,370		
Total non-interest-bearing liabilities	**54,871**			54,783			49,881		
Stockholders' equity	**44,806**			43,107			41,214		
Total liabilities & stockholders' equity	**571,975**			539,360			503,869		
Net interest income		**9,796**			9,514			9,256	
Net interest spread (5)			**3.32%**			3.48%			3.73%
Net interest income as a percentage									
of average interest-earning assets			**3.72%**			3.84%			4.02%
Ratio of interest-earning assets									
to interest-bearing liabilities			**1.12**			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 June 30, 2007, 2006 and 2005:

	For the Six Months Ended June 30,		
In thousands:	2007	2006	2005
Total interest income	$ 17,585	$ 15,707	$ 13,913
Total interest expense	8,472	6,862	5,182
Net interest income	9,113	8,845	8,731
Tax equivalent adjustment	683	669	525
Net interest income (fully taxable equivalent)	$ 9,796	$ 9,514	$ 9,256

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

	Six Months Ended June 30, 2007 vs. 2006 (1)			Six Months Ended June 30, 2006 vs. 2005 (1)		
	Change in Volume	**Change in Rate**	**Total Change**	Change in Volume	Change in Rate	Total Change
Interest Income:						
Short-term investments:						
Interest-bearing deposits at banks	**$ -**	**$ -**	**$ -**	$ -	$ -	$ -
Investment securities:						
Taxable	**85**	**303**	**388**	(24)	226	202
Tax-exempt	**3**	**-**	**3**	327	(16)	311
Total investments	**88**	**303**	**391**	303	210	513
Loans:						
Residential mortgage loans	**217**	**437**	**654**	233	122	355
Commercial & farm loans	**620**	**178**	**798**	750	164	914
Loans to state & political subdivisions	**49**	**12**	**61**	136	(3)	133
Other loans	**(37)**	**25**	**(12)**	23	-	23
Total loans, net of discount	**849**	**652**	**1,501**	1,142	283	1,425
Total Interest Income	**937**	**955**	**1,892**	1,445	493	1,938
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	**45**	**153**	**198**	41	427	468
Savings accounts	**(2)**	**5**	**3**	(2)	7	5
Money Market accounts	**50**	**189**	**239**	(11)	283	272
Certificates of deposit	**110**	**867**	**977**	(59)	213	154
	203	**1,214**	**1,417**	(31)	930	899

Total interest-bearing deposits											
Other borrowed funds		**(21)**		**214**		**193**		1,163		(382)		781
Total interest expense		**182**		**1,428**		**1,610**		1,132		548		1,680
Net interest income	**$**	**755**	**$**	**(473)**	**$**	**282**	$	313	$	(55)	$	258

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

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As can be seen from the preceding tables, we continue to experience a compression of our net interest margin. Due to the inversion of the yield curve, the net interest spread has decreased from 3.48% for the first six months of 2006 to 3.32% for the first six months of 2007. The Federal Reserve increased the Federal Funds rate 425 basis points from June 2004 to June 2006. During that period, as well as through June 2007, long-term rates have not increased proportionally. This has resulted in a flat to inverted yield curve. As such, our cost of funds (interest paid on deposits and borrowings) has increased while the rates earned on interest bearing assets have not increased accordingly. That flatness or inversion of the yield curve has remained in place for the first six months of 2007. We expect our interest margin to improve when, and if, the normal steepness of the yield curve returns. We continue to review various pricing and investment strategies in an attempt to maintain or improve upon our current interest margin. Low cost deposits continue to be our focus and are key in improving the interest margin on a go forward basis.

Tax equivalent net interest income improved from $9,514,000 in 2006 to $9,796,000, in 2007. In the period ending June 30, 2007, net interest income increased $282,000 on a tax equivalent basis over the same period in 2006. The increase in interest-earning assets of $31.0 million generated an increase in interest income of $1,892,000, with $937,000 due to volume, and $955,000 of the increase attributable to a change in rate. The yield on interest earning assets has increased 33 basis points going from 6.61% to 6.94%. Interest-bearing liabilities increased $30.8 million resulting in an increase of $1,610,000 of interest expense predominately attributable to a change in rate. Comparing the first half of 2007 with 2006, the average interest rate on interest-bearing liabilities increased 49 basis points, from 3.13% to 3.62%.

Provision For Loan Losses

For the six-month period ending June 30, 2007, we recorded $165,000 to the provision as a result of our quarterly review of the allowance for loan losses. Management's quarterly review of the allowance for loan losses is based on the following information: migration analysis of delinquent and non-accrual loans, 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 as detailed below increased $395,000 or 17.0%, for the first six months of 2007 when compared to the same period in 2006. Gains on sales of foreclosed properties increased by $349,000 due to a large pre-tax gain of $381,000 realized during the second quarter from the sale of a commercial property. Service charge income increased $45,000, or 3%, mainly derived from customers’ usage of their debit cards. This usage amounted to over $231,000 for the first six months of 2007, an improvement of 16.5% over 2006. Trust income increased $27,000 or 11.4% due to our ongoing success in growing our trust assets under management. Gains on loans sold also increased $51,000 due to more volume of secondary mortgages compared to last year. These increases were offset by brokerage income that decreased $104,000 as we have transitioned over the last several months to a new broker-dealer. We continue to emphasize the successful transition to the new broker-dealer and anticipate continued improvement over the remainder of the year.

For the three months ended June 30, 2007, non-interest income totaled $1,591,000, which is an increase of $400,000 over the comparable period last year. Most of the increase is attributable to an increase of $349,000 in gains on sales of foreclosed assets due to a large pre-tax gain of $381,000 realized during the second quarter of 2007 from the sale of a commercial property.

The following table shows the breakdown of non-interest income for the three months and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Change	
	2007	2006	Amount	%
Service charges	**$ 812**	$ 809	$ 3	0.4
Trust	**127**	108	19	17.6
Brokerage	**31**	59	(28)	(47.5)
Investment securities gains (losses), net	**-**	5	(5)	(100.0)
Gains on loans sold	**46**	7	39	557.1
Gains on sales of foreclosed properties	**373**	34	339	997.1
Earnings on bank owned life insurance	**82**	74	8	10.8
Other	**120**	95	25	26.3
Total	**$ 1,591**	$ 1,191	$ 400	33.6

	Six months ended June 30,		Change	
	2007	2006	Amount	%
Service charges	**$ 1,560**	$ 1,515	$ 45	3.0
Trust	**264**	237	27	11.4
Brokerage	**49**	153	(104)	(68.0)
Investment securities gains (losses), net	**-**	(1)	1	(100.0)
Gains on loans sold	**64**	13	51	392.3
Gains on sales of foreclosed properties	**396**	47	349	742.6
Earnings on bank owned life insurance	**162**	146	16	11.0
Other	**223**	213	10	4.7
Total	**$ 2,718**	$ 2,323	$ 395	17.0

Non-interest Expense

Total non-interest expense, as detailed below, increased $105,000 or 1.4%, for the first six months of 2007, compared to the same period in 2006. The increase is primarily due to a $100,000 write-down of one of our bank properties. The increase in salaries and employee benefits of $103,000 is due mainly to annual merit increases. Other professional fees have increased $74,000 over last year due to various consulting arrangements including an evaluation of our pension plan. Furniture and equipment costs decreased due to decreased depreciation expense from assets becoming fully depreciated. Amortization expense decreased $108,000 due to a core deposit intangible from a previous acquisition that became fully amortized in March 2006. There has been a slight overall increase in other operating expenses of $39,000, or 1.7%, over the first six months of 2007. Excluding the write-down of the bank property, expenses would have only increased by $5,000 over 2006.

Non-interest expenses totaled $3,956,000 for the three months ended June 30, 2007 compared with $3,737,000 for the comparable period last year. This is an increase of $219,000, or 5.9%. Most of the increase is attributable to a $100,000 write-down of one of our bank properties. Excluding the write-down, non-interest expenses would have increased $119,000, or 3.2% for the three months ended June 30, 2007 compared with the same period last year. Professional fees increased $$49,000 due to various consulting arrangements. Occupancy expenses increased $32,000 primarily due to additional depreciation expense related to our new branch facility in Wellsville, New York.

The following tables reflect the breakdown of non-interest expense and professional fees for the three months and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Change	
	2007	2006	Amount	%
Salaries and employee benefits	$ **2,033**	$ 1,987	$ 46	2.3
Occupancy	**308**	276	32	11.6
Furniture and equipment	**140**	144	(4)	(2.8)
Professional fees	**155**	106	49	46.2
Amortization	**36**	36	-	-
Other	**1,284**	1,188	96	8.1
Total	$ **3,956**	$ 3,737	$ 219	5.9

	Three months ended June 30,		Change	
	2007	2006	Amount	%
Other professional fees	$ **72**	$ 60	$ 12	20.0
Legal fees	**42**	10	32	320.0
Examinations and audits	**41**	36	5	13.9
Total	$ **155**	$ 106	$ 49	46.2

	Six months ended June 30,		Change	
	2007	2006	Amount	%
Salaries and employee benefits	$ **4,126**	$ 4,023	$ 103	2.6
Occupancy	**609**	584	25	4.3
Furniture and equipment	**268**	296	(28)	(9.5)
Professional fees	**320**	246	74	30.1
Amortization	**72**	180	(108)	(60.0)
Other	**2,338**	2,299	39	1.7
Total	$ **7,733**	$ 7,628	$ 105	1.4

	Six months ended June 30,		Change	
	2007	2006	Amount	%
Other professional fees	$ **188**	$ 147	$ 41	27.9
Legal fees	**55**	29	26	89.7
Examinations and audits	**77**	70	7	10.0
Total	$ **320**	$ 246	$ 74	30.1

Provision For Income Taxes

The provision for income taxes was $793,000 for the six-month period ended June 30, 2007 compared to $658,000 for the same period in 2006. Through management of our municipal loan and bond portfolios, we have achieved an effective tax rate of 20.17% for the first six months this year versus 19.24% for the first six months of 2006.

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 $616,000 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 $212,000 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 $29,000 out of a total $574,000 of tax credits. We anticipate recognizing $1,015,000 of tax credits over the next ten years.

Financial Condition

Total assets (shown in the Consolidated Balance Sheet) of $581.3 million have increased 1.6% since year-end 2006's balance of $572.2 million. Net loans have increased .1% to $411.0 million at June 30, 2007. Investment securities increased 8.1% to $118.6 million since year-end 2006. Total deposits increased $21.4 million or 4.8% to $467.9 million since year-end 2006. Borrowed funds have decreased $13.4 million to $62.4 million compared with $75.8 million at year-end. Explanations of variances will be described within the following appropriate sections.

Cash and Cash Equivalents

Cash and cash equivalents totaled $10,885,000 at June 30, 2007 compared to $10,015,000 on December 31, 2006. Non-interest-bearing cash increased temporarily $866,000 since year-end 2006, while interest-bearing cash increased $4,000 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.

Investments

As shown in the table below, our investment portfolio increased by $8,871,000 or 8.1% from December 31, 2006 to June 30, 2007. During the first two quarters of 2007 we purchased approximately $7.8 million of U.S. agency obligations, $6.7 million of mortgage-backed securities, and $1.4 million of municipal bonds offsetting the $5.7 million of principal repayments that occurred during the same time period. We continue to receive monthly principal repayments allowing us to purchase at current market yields. We have increased our investment portfolio during the second quarter primarily due to opportunities related to increases in the treasury curve. The overall market value of our investment portfolio has decreased approximately $1.2 million due to increases in interest rates since year end. Our investment portfolio is currently yielding 5.06% compared to 4.70% a year ago, on a tax equivalent basis.

Estimated Fair Market Value of Investment Portfolio

	June 30, 2007		December 31, 2006	
(dollars in thousands)	**Amount**	**%**	Amount	%
Available-for-sale:				
U. S. Agency securities	**$ 24,268**	**20.5**	$ 16,651	15.2
Obligations of state & political subdivisions	**23,573**	**19.9**	22,562	20.5
Corporate obligations	**7,757**	**6.5**	7,997	7.3
Mortgage-backed securities	**60,369**	**50.9**	59,875	54.6
Equity securities	**2,647**	**2.2**	2,658	2.4
Total	**$ 118,614**	**100.0**	$ 109,743	100.0

	June 30, 2007/ December 31, 2006 Change	
(dollars in thousands)	**Amount**	**%**
Available-for-sale:		
	$ 7,617	**45.7**

U. S. Agency securities			
Obligations of state & political subdivisions		**1,011**	**4.5**
Corporate obligations		**(240)**	**(3.0)**
Mortgage-backed securities		**494**	**0.8**
Equity securities		**(11)**	**(0.4)**
Total	**$**	**8,871**	**8.1**

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

Loans

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

As shown in the tables below (dollars in thousands), total loans increased approximately $301,000 or .1% during the first half of 2007. The increase in commercial real estate loans of $3.7 million was offset by a $3.6 million decrease in residential real estate loans with minimal change in the other loan categories.

We have experienced an overall decrease in loan demand during the first six months of 2007. Our focus continues to be on loan quality and customer relationships, which has impacted our growth during the first six months due to local and regional economic conditions. The Company's focus remains 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 dedicated, experienced professionals that enable us to meet the needs of commercial and agricultural customers within our service area. Residential mortgage lending is a principal business activity and one our Company continues to provide by offering 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.

	June 30, 2007		December 31, 2006	
(dollars in thousands)	**Amount**	**%**	Amount	%
Real estate:				
Residential	**$ 202,417**	**48.7**	$ 206,059	49.7
Commercial	**97,855**	**23.6**	94,122	22.7
Agricultural	**17,029**	**4.1**	17,054	4.1
Construction	**6,478**	**1.6**	7,027	1.7
Loans to individuals for household, family and other purchases	**12,565**	**3.0**	12,482	3.0
Commercial and other loans	**33,099**	**8.0**	32,766	7.9
State & political subdivision loans	**45,631**	**11.0**	45,263	10.9
Total loans	**415,074**	**100.0**	414,773	100.0
Less allowance for loan losses	**4,107**		3,876	
Net loans	**$ 410,967**		$ 410,897	

	June 30, 2007/ December 31, 2006 Change	
(dollars in thousands)	**Amount**	**%**
Real estate:		

Residential	$ (3,642)	(1.8)
Commercial	3,733	4.0
Agricultural	(25)	(0.1)
Construction	(549)	(7.8)
Loans to individuals for household, family and other purchases	83	0.7
Commercial and other loans	333	1.0
State & political subdivision loans	368	0.8
Total loans	$ 301	0.1

Allowance For Loan Losses

As shown in the table below, the Allowance for Loan Losses as a percentage of loans increased from .93% at December 31, 2006 to .99% at June 30, 2007. The dollar amount of the reserve increased $231,000 since year-end 2006. The increase is a result of a $165,000 provision for the first six months, losses of $58,000, and recoveries of $124,000, which includes $79,000 from one large commercial relationship.

	June 30,	December 31,			
(dollars in thousands)	**2007**	2006	2005	2004	2003
Balance, at beginning of period	**$ 3,876**	$ 3,664	$ 3,919	$ 3,620	$ 3,621
Provision charged to income	**165**	330	60	-	435
Increase related to acquisition	**-**	-	-	290	-
Recoveries on loans previously charged against the allowance	**124**	172	57	324	116
	4,165	4,166	4,036	4,234	4,172
Loans charged against the allowance	**(58)**	(290)	(372)	(315)	(552)
Balance, at end of year	**$ 4,107**	$ 3,876	$ 3,664	$ 3,919	$ 3,620
Allowance for loan losses as a percent of total loans	**0.99%**	0.93%	0.96%	1.09%	1.14%
Allowance for loan losses as a percent of non-performing loans	**157.12%**	115.43%	163.94%	176.53%	134.62%

The adequacy of the allowance for loan losses is subject to a formal analysis by management of the Company. Management deems the allowance to be adequate to absorb inherent losses probable in the portfolio, as of June 30, 2007. The Company has disclosed in its annual report on Form 10-K for the year ended December 31, 2006 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).

	June 30,	December 31,			
(dollars in thousands)	**2007**	2006	2005	2004	2003
Non-performing loans:					
Non-accruing loans	**$ 328**	$ 478	$ 867	$ 722	$ 578
Impaired loans	**1,920**	1,190	1,031	1,061	1,926
Accrual loans - 90 days or more past due	**366**	1,690	337	437	185
Total non-performing loans	**2,614**	3,358	2,235	2,220	2,689
Foreclosed assets held for sale	**140**	758	619	712	305
Total non-performing assets	**$ 2,754**	$ 4,116	$ 2,854	$ 2,932	$ 2,994
Non-performing loans as a percent of loans net of unearned income	**0.63%**	0.81%	0.58%	0.62%	0.85%

Non-performing assets as a percent of loans net of unearned income	**0.66%**	0.99%	0.75%	0.82%	0.94%

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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. The decrease in accrual loans – 90 days or more past due for the first six months is primarily due to a temporary delay in payment from one large commercial customer at December 31, 2006. The decrease in foreclosed assets held for sale is due to the aforementioned sale of a large commercial property.

Bank Owned Life Insurance

The Company has purchased bank owned life insurance to offset future employee benefit costs. As of June 30, 2007 the cash surrender value of this life insurance is $8,209,000, an increase of $162,000 since year end. The use of life insurance policies provides the bank with an asset that will generate earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits.

Deposits

Traditional deposits continue to be the most significant source of funds for the Company. As shown in the following tables, deposits increased $21,427,000 or 4.8%, since December 31, 2006. As of June 30, 2007, non-interest-bearing deposits increased by $2,244,000, NOW accounts increased by $14,613,000, savings accounts increased $1,315,000, and money market deposit accounts increased $4,390,000. The large increase in NOW accounts and money market deposits was mainly due to increases in deposits of municipalities related primarily to real estate tax receipts during the second quarter of 2007. Brokered certificates of deposit also increased by $3,454,000, due to acquiring short-term brokered deposits at more favorable pricing compared to other wholesale borrowing alternatives. Certificates of deposit have declined by $4,589,000 since year end 2006.

	June 30, 2007		December 31, 2006	
(in thousands)	**Amount**	**%**	Amount	%
Non-interest-bearing deposits	**$ 50,753**	**10.9**	$ 48,509	10.9
NOW accounts	**100,680**	**21.5**	86,067	19.3
Savings deposits	**38,952**	**8.3**	37,637	8.4
Money market deposit accounts	**50,456**	**10.8**	46,066	10.3
Brokered certificates of deposit	**17,307**	**3.7**	13,853	3.1
Certificates of deposit	**209,794**	**44.8**	214,383	48.0
Total	**$ 467,942**	**100.0**	$ 446,515	100.0

	June 30, 2007/ December 31, 2006 Change	
(in thousands)	**Amount**	**%**
Non-interest-bearing deposits	**$ 2,244**	**4.6**
NOW accounts	**14,613**	**17.0**
Savings deposits	**1,315**	**3.5**
Money market deposit accounts	**4,390**	**9.5**
	3,454	**24.9**

Brokered certificates of deposit			
Certificates of deposit		**(4,589)**	**(2.1)**
Total	**$**	**21,427**	**4.8**

Borrowed Funds

Borrowed funds decreased $13,393,000 during the first six months of 2007. The increase in deposits, offset by investment purchases, resulted in the net decrease compared to December 31, 2006. 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 is determined quarterly and floats based on the 3 month LIBOR plus 2.80%. At June 30, 2007, the rate was 8.16%. The Entity may redeem them, in whole or in part, at face value after December 17, 2008. The Company borrowed the proceeds of the issuance from the Entity in December 2003 in the form of a $7,500,000 note payable, which is included within borrowed funds in the liabilities section of the Company's balance sheet. Under current accounting rules, the Company's minority interest in the Entity was recorded at the initial investment amount and is included in the other assets section of the balance sheet. The Entity is not consolidated as part of the Company's consolidated financial statements.

Stockholder's Equity

We evaluate stockholders' equity in relation to total assets and the risks associated with those assets. The greater the capital resource, the more likely a corporation is to 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 $44,340,000 at June 30, 2007 compared to $43,500,000, at December 31, 2006, an increase of $840,000 or 1.9%. Excluding accumulated other comprehensive loss, stockholder's equity increased $1,654,000, or 3.7%. In the first six months of 2007, the Company had net income of $3,140,000 and paid dividends of $1,255,000, representing a dividend payout ratio of 40.0%. The Company also purchased 10,835 shares of treasury stock for $244,000 at a weighted average cost of $22.56 per share during the first six months of 2007.

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 loss decreased $814,000 compared to December 31, 2006 as a result of interest rate movements.

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:

	June 30,		December 31,	
(dollars in thousand)	**2007**		2006	
Total capital (to risk-weighted assets)	Amount	Ratio	Amount	Ratio
Company	**$49,596**	**12.96%**	$47,604	12.59%
For capital adequacy purposes	**30,606**	**8.00%**	30,252	8.00%
To be well capitalized	**38,258**	**10.00%**	37,815	10.00%
Tier I capital (to risk-weighted assets)				
Company	**$45,481**	**11.89%**	$43,684	11.55%
For capital adequacy purposes	**15,303**	**4.00%**	15,126	4.00%
To be well capitalized	**22,955**	**6.00%**	22,689	6.00%
Tier I capital (to average assets)				
Company	**$45,481**	**8.05%**	$43,684	7.82%
For capital adequacy purposes	**22,590**	**4.00%**	22,355	4.00%
To be well capitalized	**28,237**	**5.00%**	27,944	5.00%

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

(dollars in thousand)	**June 30, 2007**		December 31, 2006	
Total capital (to risk-weighted assets)	Amount	Ratio	Amount	Ratio
Bank	**$43,371**	**11.35%**	$41,249	10.93%
For capital adequacy purposes	**30,571**	**8.00%**	30,200	8.00%
To be well capitalized	**38,214**	**10.00%**	37,750	10.00%
Tier I capital (to risk-weighted assets)				
Bank	**$39,252**	**10.27%**	$37,330	9.89%
For capital adequacy purposes	**15,286**	**4.00%**	15,100	4.00%
To be well capitalized	**22,928**	**6.00%**	22,650	6.00%
Tier I capital (to average assets)				
Bank	**$39,252**	**6.94%**	$37,330	6.68%
For capital adequacy purposes	**22,613**	**4.00%**	22,373	4.00%
To be well capitalized	**28,266**	**5.00%**	27,966	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 June 30, 2007 (dollars in thousands):

Commitments to extend credit	$ 75,769
Standby letters of credit	2,204
	$ 77,973

Liquidity

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

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

Cash generated by operating activities, investing activities and financing activities influences liquidity management. The most important source of funds is the deposits that are primarily core deposits (deposits from customers with other relationships). Short-term debt from the Federal Home Loan Bank supplements our Company’s availability of funds as well as line of credit arrangements with corresponding banks. Other sources of short-term funds include brokered CD’s and the sale of loans, if needed.

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

Capital expenditures during the first six months of 2007 were $273,000, approximately the same as the $269,000 that was expended for the same period last year.

Our Company achieves additional liquidity primarily from temporary or short-term borrowings from the Federal Home Loan Bank of Pittsburgh, PA, and other wholesale borrowing alternatives that mature in less than one year. The Company also has a maximum borrowing capacity at the Federal Home Loan Bank of approximately $225.8 million as an additional source of liquidity, of which $47.2 million is outstanding.

Interest Rate and Market Risk Management

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

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

Currently, our Company has equity securities that represent only 2.0% of our investment portfolio and, therefore, market 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 second quarter of 2007 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, and is within our Company’s policy limit to manage interest rate risk effectively.

Item 3-Quantitative and Qualitative Disclosure About Market Risk

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

No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the SEC Form 10-K for the period ended December 31, 2006.

Item 4-Control and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, within 90 days prior to the filing date of this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic Securities and Exchange Commission filings. No significant changes were made to our internal controls or other factors during the quarter ended, June 30, 2007, that could significantly affect these controls subsequent to the date of their evaluation.

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, 2006, which could materially affect our business, financial condition or future results. At June 30, 2007 the risk factors of the Company have not changed materially from those reported in our Annual Report on Form 10-K. However, the risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares (or units Purchased)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1)
4/1/07 to 4/30/07	-	-	-	101,796
5/1/07 to 5/31/07	8,506	$22.76	8,506	93,290
6/1/07 to 6/30/07	2,079	$21.82	2,079	91,211
Total	**10,585**	**$22.57**	**10,585**	**91,211**

(1) On January 7, 2006, the Board of Directors authorized the repurchase of 140,000 shares, as filed with the Securities and Exchange Commission on January 20, 2006 on Form 8-K. 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

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	Instrument defining the rights of security holders.[(3)]
10.1	Amended and Restated Executive Employment Agreement between Citizens Financial Services, Inc., First Citizens National Bank and Randall E. Black[(4)]
10.2	Consulting and Non-Compete Agreement between Citizens Financial Services, Inc., First Citizens National Bank and Richard E. Wilber[(5)]
10.3	Citizens Financial Services, Inc. Directors' Deferred Compensation Plan[(6)]
10.4	Citizens Financial Services, Inc. Directors' Life Insurance Program[(7)]
10.5	Citizens Financial Services, Inc. 2006 Restricted Stock Plan[(8)]
11	Statement re computation of per share earnings[(9)]
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

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(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.

(4) Incorporated by reference to Exhibit 99.1 of the Form 8-K filed with the Commission on September 19, 2006.

(5) Incorporated by Reference to Exhibit 10.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003, as filed with the Commission on March 18, 2004.

(6) Incorporated by reference to Exhibit 10.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Commission on March 14, 2005.

(7) Incorporated by reference to Exhibit 10.4 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as filed with the Commission on March 14, 2005.

(8) Incorporated by reference to Exhibit 4.1 to the Company's Form S-8, as filed with the Commission on August 29, 2006.

(9) The statement regarding computation of per share earnings required by this exhibit is contained in Note 2 to the consolidated financial statements captioned "Earnings Per Share" in Part I, Item 1 of this report.

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.
(Registrant)

Citizens Financial Services, Inc.
(Registrant)

Date: August 9, 2007 By: /s/ Randall E. Black
By: Randall E. Black
President and Chief Executive Officer
(Prinicpal Executive Officer)

Date: August 9, 2007 By: /s/ Mickey L. Jones
By: Mickey L. Jones
Chief Financial Officer
(Principal Accounting Officer)