

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
November 12, 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 September 30, 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  
(State or other jurisdiction of incorporation or organization)  
Identification No.)

23-2265045  
(I.R.S. Employer

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

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.

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Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of outstanding shares of the Registrant's Common Stock, as of November 9, 2009, was 2,873,966.

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Citizens Financial Services, Inc.  
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CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

| (in thousands, except share and per share data)  | September 30<br>2009 | December 31<br>2008 |
|--|----------------------|---------------------|
| <b>ASSETS:</b>   |                      |                     |
| Cash and due from banks:   |                      |                     |
| Noninterest-bearing  | \$ 10,844            | \$ 9,692            |
| Interest-bearing   | 9,318                | 10,164              |
| Total cash and cash equivalents  | 20,162               | 19,856              |
| Available-for-sale securities  | 197,544              | 174,139             |
| Loans (net of allowance for loan losses:<br>2009, \$4,683 and 2008, \$4,378)                             |                      |                     |
|  | 443,808              | 428,436             |
| Premises and equipment   | 11,896               | 12,762              |
| Accrued interest receivable  | 3,544                | 2,912               |
| Goodwill   | 10,256               | 10,256              |
| Bank owned life insurance  | 12,539               | 12,176              |
| Other assets   | 7,465                | 8,075               |
| <b>TOTAL ASSETS</b>  | <b>\$ 707,214</b>    | <b>\$ 668,612</b>   |
| <b>LIABILITIES:</b>  |                      |                     |
| Deposits:  |                      |                     |
| Noninterest-bearing  | \$ 56,070            | \$ 55,545           |
| Interest-bearing   | 523,777              | 491,135             |
| Total deposits   | 579,847              | 546,680             |
| Borrowed funds   | 57,790               | 61,204              |
| Accrued interest payable   | 2,075                | 2,233               |
| Other liabilities  | 6,395                | 5,725               |
| <b>TOTAL LIABILITIES</b>   | <b>646,107</b>       | <b>615,842</b>      |
| <b>STOCKHOLDERS' EQUITY:</b>   |                      |                     |
| Common stock   |                      |                     |
| \$1.00 par value; authorized 10,000,000 shares; issued<br>3,076,253 shares                               |                      |                     |
| at September 30, 2009 and 3,048,289 shares at December 31,<br>2008, respectively                         | 3,076                | 3,048               |
| Additional paid-in capital   | 13,455               | 12,981              |
| Retained earnings  | 45,557               | 41,034              |
| Accumulated other comprehensive income   | 3,365                | 26                  |
| Treasury stock, at cost: 202,287 shares at September 30, 2009<br>and 200,918 shares at December 31, 2008 | (4,346)              | (4,319)             |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  | <b>61,107</b>        | <b>52,770</b>       |
| <b>TOTAL LIABILITIES AND<br/>STOCKHOLDERS' EQUITY</b>  | <b>\$ 707,214</b>    | <b>\$ 668,612</b>   |

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

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

| (in thousands, except share and per share data)                | Three Months Ended<br>September 30, |                   | Nine Months Ended<br>September 30, |                 |
|--|-------------------------------------|-------------------|------------------------------------|-----------------|
|  | 2009                                | 2008              | 2009                               | 2008            |
| <b>INTEREST INCOME:</b>  |                                     |                   |                                    |                 |
| Interest and fees on loans                                     | \$ 7,581                            | \$ 7,793          | \$ 22,616                          | \$ 23,102       |
| Interest-bearing deposits with banks                           | 15                                  | 28                | 27                                 | 34              |
| Investment securities:   |                                     |                   |                                    |                 |
| Taxable  | 1,466                               | 1,142             | 4,647                              | 3,391           |
| Nontaxable   | 598                                 | 359               | 1,583                              | 1,048           |
| Dividends  | 7                                   | 23                | 20                                 | 164             |
| <b>TOTAL INTEREST INCOME</b>                                   | <b>9,667</b>                        | <b>9,345</b>      | <b>28,893</b>                      | <b>27,739</b>   |
| <b>INTEREST EXPENSE:</b>                                       |                                     |                   |                                    |                 |
| Deposits   | 2,777                               | 2,837             | 8,555                              | 8,508           |
| Borrowed funds   | 500                                 | 545               | 1,519                              | 2,030           |
| <b>TOTAL INTEREST EXPENSE</b>                                  | <b>3,277</b>                        | <b>3,382</b>      | <b>10,074</b>                      | <b>10,538</b>   |
| <b>NET INTEREST INCOME</b>                                     | <b>6,390</b>                        | <b>5,963</b>      | <b>18,819</b>                      | <b>17,201</b>   |
| Provision for loan losses                                      | 400                                 | 105               | 700                                | 225             |
| <b>NET INTEREST INCOME AFTER<br/>PROVISION FOR LOAN LOSSES</b> | <b>5,990</b>                        | <b>5,858</b>      | <b>18,119</b>                      | <b>16,976</b>   |
| <b>NON-INTEREST INCOME:</b>                                    |                                     |                   |                                    |                 |
| Service charges  | 958                                 | 944               | 2,664                              | 2,591           |
| Trust  | 121                                 | 148               | 397                                | 451             |
| Brokerage and insurance  | 75                                  | 58                | 228                                | 176             |
| Gains on loans sold  | 83                                  | 4                 | 292                                | 45              |
| Investment securities gains (losses), net                      | -                                   | (4,089)           | 118                                | (4,089)         |
| Earnings on bank owned life insurance                          | 128                                 | 90                | 364                                | 261             |
| Other  | 87                                  | 121               | 278                                | 368             |
| <b>TOTAL NON-INTEREST INCOME (LOSS)</b>                        | <b>1,452</b>                        | <b>(2,724)</b>    | <b>4,341</b>                       | <b>(197)</b>    |
| <b>NON-INTEREST EXPENSES:</b>                                  |                                     |                   |                                    |                 |
| Salaries and employee benefits                                 | 2,393                               | 2,196             | 7,018                              | 6,510           |
| Occupancy  | 272                                 | 271               | 889                                | 866             |
| Furniture and equipment  | 102                                 | 107               | 336                                | 368             |
| Professional fees  | 164                                 | 156               | 459                                | 485             |
| FDIC insurance   | 277                                 | 52                | 1,030                              | 104             |
| Other  | 1,242                               | 1,250             | 3,581                              | 3,552           |
| <b>TOTAL NON-INTEREST EXPENSES</b>                             | <b>4,450</b>                        | <b>4,032</b>      | <b>13,313</b>                      | <b>11,885</b>   |
| Income (loss) before provision for income taxes                | 2,992                               | (898)             | 9,147                              | 4,894           |
| Provision for income taxes                                     | 604                                 | 154               | 1,941                              | 1,479           |
| <b>NET INCOME (LOSS)</b>                                       | <b>\$ 2,388</b>                     | <b>\$ (1,052)</b> | <b>\$ 7,206</b>                    | <b>\$ 3,415</b> |
| <b>Earnings Per Share</b>                                      | <b>\$ 0.83</b>                      | <b>\$ (0.37)</b>  | <b>\$ 2.51</b>                     | <b>\$ 1.19</b>  |
| <b>Cash Dividends Paid Per Share</b>                           | <b>\$ 0.245</b>                     | <b>\$ 0.235</b>   | <b>\$ 0.730</b>                    | <b>\$ 0.700</b> |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Weighted average number of shares<br>outstanding | 2,873,966 | 2,877,510 | 2,873,520 | 2,879,853 |
|--|-----------|-----------|-----------|-----------|

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 |            | Nine Months Ended |          |
|--|--------------------|------------|-------------------|----------|
|  | September 30,      |            | September 30,     |          |
|  | 2009               | 2008       | 2009              | 2008     |
| Net income (loss)  | \$ 2,388           | \$ (1,052) | \$ 7,206          | \$ 3,415 |
| Other comprehensive income:  |                    |            |                   |          |
| Unrealized gains (losses) on available for sale securities               | 4,385              | (6,078)    | 5,054             | (7,548)  |
| Change in unrealized gain (loss) on interest rate swap                   | (115)              | -          | 123               | -        |
| Less: Reclassification adjustment for loss (gain) included in net income | -                  | 4,089      | (118)             | 4,089    |
| Other comprehensive income (loss) before tax                             | 4,270              | (1,989)    | 5,059             | (3,459)  |
| Income tax expense (benefit) related to other comprehensive income       | 1,452              | (676)      | 1,720             | (1,176)  |
| Other comprehensive income (loss), net of tax                            | 2,818              | (1,313)    | 3,339             | (2,283)  |
| Comprehensive income (loss)  | \$ 5,206           | \$ (2,365) | \$ 10,545         | \$ 1,132 |

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



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

| (in thousands)  | Nine Months Ended<br>September 30, |          |
|---|------------------------------------|----------|
|   | 2009                               | 2008     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                    |          |
| Net income  | \$ 7,206                           | \$ 3,415 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |          |
| Provision for loan losses   | 700                                | 225      |
| Depreciation and amortization   | 476                                | 474      |
| Amortization and accretion of investment securities                               | 277                                | 8        |
| Deferred income taxes   | 155                                | (396)    |
| Investment securities (gains) losses, net   | (118)                              | 4,089    |
| Realized gains on loans sold  | (292)                              | (46)     |
| Earnings on bank owned life insurance   | (364)                              | (261)    |
| Originations of loans held for sale   | (17,546)                           | (3,823)  |
| Proceeds from sales of loans held for sale  | 17,838                             | 3,869    |
| Loss (gain) on sale of foreclosed assets held for sale                            | 40                                 | (24)     |
| Increase in accrued interest receivable   | (632)                              | (255)    |
| Decrease in accrued interest payable  | (159)                              | (151)    |
| Other, net  | 95                                 | (761)    |
| Net cash provided by operating activities   | 7,676                              | 6,363    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                    |          |
| Available-for-sale securities:  |                                    |          |
| Proceeds from sales of available-for-sale-securities                              | 6,778                              | 162      |
| Proceeds from maturity and principal repayments of securities                     | 35,143                             | 11,621   |
| Purchase of securities  | (60,548)                           | (26,766) |
| Proceeds from redemption of regulatory stock                                      | -                                  | 4,953    |
| Purchase of regulatory stock  | (586)                              | (3,187)  |
| Net increase in loans   | (16,287)                           | (6,485)  |
| Purchase of premises and equipment  | (1,063)                            | (249)    |
| Proceeds from sale of premises and equipment                                      | 1,406                              | 213      |
| Proceeds from sale of foreclosed assets held for sale                             | 313                                | 109      |
| Net cash used in investing activities   | (34,844)                           | (19,629) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                    |          |
| Net increase in deposits  | 33,168                             | 58,924   |
| Proceeds from long-term borrowings  | 10,545                             | 21,312   |
| Repayments of long-term borrowings  | (14,050)                           | (17,493) |
| Net increase (decrease) in short-term borrowed funds                              | 91                                 | (31,542) |
| Purchase of treasury stock  | (192)                              | (244)    |
| Dividends paid  | (2,088)                            | (1,988)  |
| Net cash provided by financing activities   | 27,474                             | 28,969   |
| Net increase in cash and cash equivalents   | 306                                | 15,703   |

|  |           |           |
|--|-----------|-----------|
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD   | 19,856    | 10,389    |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD         | \$ 20,162 | \$ 26,092 |
| Supplemental Disclosures of Cash Flow Information: |           |           |
| Interest paid                                      | \$ 10,233 | \$ 10,689 |
| Income taxes paid                                  | \$ 2,025  | \$ 2,015  |
| Loans transferred to foreclosed property           | \$ 410    | \$ 747    |

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 September 30, 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 nine-month period ended September 30, 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 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 |               | Nine months ended |             |
|--|--------------------|---------------|-------------------|-------------|
|  | September 30,      |               | September 30,     |             |
|  | 2009               | 2008          | 2009              | 2008        |
| Net income (loss) applicable to common stock | \$2,388,000        | (\$1,052,000) | \$7,206,000       | \$3,415,000 |
| Weighted average common shares outstanding   | 2,873,966          | 2,877,510     | 2,873,520         | 2,879,853   |
| Earnings per share                           | \$0.83             | (\$0.37)      | \$2.51            | \$1.19      |

#### 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 – Investments

The amortized cost and estimated fair value of investment securities at September 30, 2009 and December 31, 2008 were as follows (in thousands):

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| September 30, 2009                                 | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| Available-for-sale securities:                     |                   |                              |                               |                            |
| U.S. Agency securities                             | \$ 52,717         | \$ 1,223                     | \$ (9)                        | \$ 53,931                  |
| Obligations of state and<br>political subdivisions | 58,061            | 2,798                        | (11)                          | 60,848                     |
| Corporate obligations                              | 5,969             | 193                          | (24)                          | 6,138                      |
| Mortgage-backed securities                         | 72,651            | 3,417                        | -                             | 76,068                     |
| Equity securities                                  | 431               | 129                          | (1)                           | 559                        |
| Total available-for-sale securities                | \$ 189,829        | \$ 7,760                     | \$ (45)                       | \$ 197,544                 |

| December 31, 2008                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| Available-for-sale securities:                     |                   |                              |                               |                            |
| U.S. Agency securities                             | \$ 27,628         | \$ 1,314                     | \$ -                          | \$ 28,942                  |
| Obligations of state and<br>political subdivisions | 44,188            | 424                          | (480)                         | 44,132                     |
| Corporate obligations                              | 5,964             | -                            | (668)                         | 5,296                      |
| Mortgage-backed securities                         | 93,037            | 2,437                        | (67)                          | 95,407                     |
| Equity securities                                  | 545               | 20                           | (203)                         | 362                        |
| Total available-for-sale securities                | \$ 171,362        | \$ 4,195                     | \$ (1,418)                    | \$ 174,139                 |

The following table shows the Company's gross unrealized losses and estimated fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at September 30, 2009 and December 31, 2008 (in thousands). As of September 30, 2009 and December 31, 2008, the Company owned 7 and 47 securities whose estimated fair value was less than their cost basis, respectively.

| September 30, 2009                                  | Less than Twelve Months    |                               | Twelve Months or Greater   |                               | Total                      |                               |
|---|----------------------------|-------------------------------|----------------------------|-------------------------------|----------------------------|-------------------------------|
|   | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Losses |
| U.S. Agency securities                              | \$ 4,893                   | \$ 9                          | \$ -                       | \$ -                          | \$ 4,893                   | \$ 9                          |
| Obligations of states and<br>political subdivisions | -                          | -                             | 870                        | 11                            | 870                        | 11                            |
| Corporate obligations                               | -                          | -                             | 1,002                      | 24                            | 1,002                      | 24                            |
| Mortgage-backed securities                          | -                          | -                             | -                          | -                             | -                          | -                             |
| Total debt securities                               | 4,893                      | 9                             | 1,872                      | 35                            | 6,765                      | 44                            |
| Equity securities                                   | -                          | 1                             | -                          | -                             | -                          | 1                             |
| Total securities                                    | \$ 4,893                   | \$ 10                         | \$ 1,872                   | \$ 35                         | \$ 6,765                   | \$ 45                         |

| December 31, 2008                                   | Less than Twelve Months |                      | Twelve Months or Greater |                      | Total         |                      |
|---|-------------------------|----------------------|--------------------------|----------------------|---------------|----------------------|
|   | Estimated               | Gross                | Estimated                | Gross                | Estimated     | Gross                |
|   | Fair<br>Value           | Unrealized<br>Losses | Fair<br>Value            | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| U.S. Agency securities                              | \$ -                    | \$ -                 | \$ -                     | \$ -                 | \$ -          | \$ -                 |
| Obligations of states and<br>political subdivisions | 16,910                  | 463                  | 1,348                    | 17                   | 18,258        | 480                  |
| Corporate obligations                               | 1,874                   | 135                  | 3,421                    | 533                  | 5,295         | 668                  |
| Mortgage-backed securities                          | 9,413                   | 67                   | -                        | -                    | 9,413         | 67                   |
| Total debt securities                               | 28,197                  | 665                  | 4,769                    | 550                  | 32,966        | 1,215                |
| Equity securities                                   | 231                     | 203                  | -                        | -                    | 231           | 203                  |
| Total securities                                    | \$ 28,428               | \$ 868               | \$ 4,769                 | \$ 550               | \$ 33,197     | \$ 1,418             |

The Company's investment securities portfolio contains unrealized losses on U.S. Agency securities issued or backed by the full faith and credit of the U.S. government or are generally viewed as having the implied guarantee of the U.S. government. For fixed maturity investments with unrealized losses due to interest rates where the Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell the investment before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an impairment loss unless sufficient evidence is available that the decline is not other than temporary and a recovery period can be predicted. The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not other than temporary and is not credit related. Rather, it is the result of interest rate changes, sector credit rating changes, or company-specific rating changes that are not expected to result in the non-collection of principal and interest during the period.

Proceeds from sales of securities available-for-sale for the nine months ended September 30, 2009 and 2008 were \$6,778,000 and \$162,000, respectively. For the three months ended September 30, 2009 and 2008, proceeds from sales of securities available-for-sale were \$0 and \$162,000, respectively. The gross gains and losses were as follows (in thousands):

|                    | Three Months Ended    |            | Nine Months Ended     |            |
|--------------------|-----------------------|------------|-----------------------|------------|
|                    | September 30,<br>2009 | 2008       | September 30,<br>2009 | 2008       |
| Gross gains        | \$ -                  | \$ 43      | \$ 209                | \$ 43      |
| Gross losses       | -                     | 4,132      | 91                    | 4,132      |
| Net gains (losses) | \$ -                  | \$ (4,089) | \$ 118                | \$ (4,089) |

Investment securities with an approximate carrying value of \$143,211,000 and \$106,669,000 at September 30, 2009 and December 31, 2008, respectively, were pledged to secure public funds and certain other deposits as provided by law.

Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and estimated fair value of debt securities at September 30, 2009, by contractual maturity, are shown below (in thousands):

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|  | Amortized<br>Cost | Estimated<br>Fair Value |
|--|-------------------|-------------------------|
| Available-for-sale debt securities:    |                   |                         |
| Due in one year or less                | \$ 2,799          | \$ 2,851                |
| Due after one year through five years  | 18,265            | 18,826                  |
| Due after five years through ten years | 35,217            | 36,468                  |
| Due after ten years                    | 133,117           | 138,840                 |
| Total                                  | \$ 189,398        | \$ 196,985              |

#### Note 5 - 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.

#### Noncontributory Defined Benefit Pension Plan

The Bank sponsors a noncontributory defined benefit pension plan ("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 Pension 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, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

The Pension Plan was also amended, effective January 1, 2008, for employees who are still eligible to participate. The amended Pension 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 Pension Plan.

The following sets forth the components of net periodic benefit costs of the Pension Plan for the three and nine months ended September 30, 2009 and 2008, respectively (in thousands):

|                                | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |        |
|--------------------------------|-------------------------------------|-------|------------------------------------|--------|
|                                | 2009                                | 2008  | 2009                               | 2008   |
| Service cost                   | \$ 90                               | \$ 24 | \$ 240                             | \$ 300 |
| Interest cost                  | 116                                 | 30    | 309                                | 378    |
| Expected return on plan assets | (113)                               | (37)  | (302)                              | (466)  |
| Net amortization and deferral  | 37                                  | 1     | 99                                 | 16     |
| Net periodic benefit cost      | \$ 130                              | \$ 18 | \$ 346                             | \$ 228 |

The Company expects to contribute, and has contributed, \$500,000 to the Pension Plan in 2009.





#### Defined Contribution Plan

The Company sponsors a voluntary 401(k) savings plan (“401(k) 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 401(k) Plan was amended, effective January 1, 2008. Under the amended 401(k) 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 \$159,000 and \$156,000 for the nine months ended September 30, 2009 and 2008, respectively.

#### Directors’ Deferred Compensation Plan

The Company’s directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. Amounts included in interest expense on the deferred amounts totaled \$28,000 and \$29,000 for the nine months ended September 30, 2009 and 2008, respectively.

#### Restricted Stock Plan

Effective April 18, 2006, shareholders of the Company approved the 2006 Restricted Stock Plan (the “Plan”). Employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company’s common stock and are subject to certain vesting requirements including continuous employment or service with the Company. 100,000 shares of the Company’s common stock have been authorized under the Plan, which terminates April 18, 2016. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

For the nine months ended September 30, 2009 and 2008, 7,526 and 4,993 shares of restricted stock were awarded and 2,517 and 1,133 shares were vested, respectively. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. Compensation expense related to restricted stock was \$72,000 and \$37,000 for the nine months ended September 30, 2009 and 2008, respectively.

#### Note 6 – Fair Value Measurements

Effective January 1, 2008, the Company adopted FASB ASC Topic 820, Fair Value Measurements and Disclosures, which, among other things, requires enhanced disclosures about assets and liabilities carried at fair value. FASB ASC Topic 820 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 FASB ASC Topic 820 hierarchy are as follows:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities

include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

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The following tables present the assets reported on the consolidated statements of financial condition at their fair value as of September 30, 2009 and December 31, 2008 by level within the fair value hierarchy. As required by FASB ASC Topic 820, 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)                                    | September 30, 2009 |           |           | Total     |
|---|--------------------|-----------|-----------|-----------|
|   | Level 1            | Level II  | Level III |           |
| Fair value measurements on a recurring basis:     |                    |           |           |           |
| Securities available for sale:                    |                    |           |           |           |
| U.S. Agency securities                            |                    | \$ 53,931 |           | \$ 53,931 |
| Obligations of state and political subdivisions   |                    | \$ 60,848 |           | \$ 60,848 |
| Corporate obligations                             |                    | \$ 6,138  |           | \$ 6,138  |
| Mortgage-backed securities                        |                    | \$ 76,068 |           | \$ 76,068 |
| Equity securities                                 | \$ 559             |           |           | \$ 559    |
| Trust Preferred Interest Rate Swap                |                    | \$ (221)  |           | \$ (221)  |
| Fair value measurements on a non-recurring basis: |                    |           |           |           |
| Impaired Loans                                    |                    | \$ 724    |           | \$ 724    |

| (In thousands)                                    | December 31, 2008 |           |           | Total     |
|---|-------------------|-----------|-----------|-----------|
|   | Level 1           | Level II  | Level III |           |
| Fair value measurements on a recurring basis:     |                   |           |           |           |
| Securities available for sale:                    |                   |           |           |           |
| U.S. Agency securities                            |                   | \$ 28,942 |           | \$ 28,942 |
| Obligations of state and political subdivisions   |                   | \$ 44,132 |           | \$ 44,132 |
| Corporate obligations                             |                   | \$ 5,296  |           | \$ 5,296  |
| Mortgage-backed securities                        |                   | \$ 95,407 |           | \$ 95,407 |
| Equity securities                                 | \$ 362            |           |           | \$ 362    |
| Trust Preferred Interest Rate Swap                |                   | \$ (330)  |           | \$ (330)  |
| Fair value measurements on a non-recurring basis: |                   |           |           |           |
| Impaired Loans                                    |                   | \$ 830    |           | \$ 830    |

The estimated fair values of the Company's financial instruments are as follows (in thousands):

|                               | September 30<br>2009 |                         | December 31<br>2008 |                         |
|-------------------------------|----------------------|-------------------------|---------------------|-------------------------|
|                               | Carrying<br>Amount   | Estimated<br>Fair Value | Carrying<br>Amount  | Estimated<br>Fair Value |
| <b>Financial assets:</b>      |                      |                         |                     |                         |
| Cash and cash equivalents     | \$ 20,162            | \$ 20,162               | \$ 19,856           | \$ 19,856               |
| Available-for-sale securities | 197,544              | 197,544                 | 174,139             | 174,139                 |
| Net loans                     | 443,808              | 460,760                 | 428,436             | 445,571                 |
| Bank owned life insurance     | 12,539               | 12,539                  | 12,176              | 12,176                  |
| Regulatory stock              | 3,956                | 3,956                   | 3,371               | 3,371                   |
| Accrued interest receivable   | 3,544                | 3,544                   | 2,912               | 2,912                   |
| <b>Financial liabilities:</b> |                      |                         |                     |                         |
| Deposits                      | \$579,847            | \$587,748               | \$ 546,680          | \$555,089               |
| Borrowed funds                | 57,790               | 54,516                  | 61,204              | 60,823                  |
| Accrued interest payable      | 2,075                | 2,075                   | 2,233               | 2,233                   |

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the estimates.

Estimated fair values have been determined by the Company using historical data, as generally provided in the Company's regulatory reports, and an estimation methodology suitable for each category of financial instruments. The Company's fair value estimates, methods and assumptions are set forth below for the Company's other financial instruments.

#### Cash and Cash Equivalents:

The carrying amounts for cash and due from banks approximate fair value because they mature within one year and do not present unanticipated credit concerns.

#### Accrued Interest Receivable and Payable:

The carrying amounts for accrued interest receivable and payable approximate fair value because they are generally received or paid in 90 days or less and do not present unanticipated credit concerns.

#### Available-For-Sale Securities:

The fair values of available-for-sale securities are based on quoted market prices as of the balance sheet date. For certain instruments, fair value is estimated by obtaining quotes from independent dealers.



Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans has been estimated by discounting expected future cash flows. The discount rate used in these calculations is derived from the Treasury yield curve adjusted for credit quality, operating expense and prepayment option price, and is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified as required by an estimate of the effect of current economic and lending conditions.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discount rates are judgmentally determined using available market information and specific borrower information.

Bank Owned Life Insurance:

The carrying value of bank owned life insurance approximates fair value based on applicable redemption provisions.

Regulatory Stock:

The carrying value of regulatory stock approximates fair value based on applicable redemption provisions.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings and NOW accounts, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The deposits' fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

Borrowed Funds:

Rates available to the Company for borrowed funds with similar terms and remaining maturities are used to estimate the fair value of borrowed funds.

Note 7 – Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2009-01, Topic 105 - Generally Accepted Accounting Principles - FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles. The Codification is the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. Rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. The Company adopted this standard for the interim reporting period ending September 30, 2009. The adoption of this standard did not have a material impact on the Company's results of operations or financial position.

In June 2009, the FASB issued an accounting standard related to the accounting for transfers of financial assets, which is effective for fiscal years beginning after November 15, 2009, and interim periods within those fiscal years. This standard enhances reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. This standard eliminates the concept of a “qualifying special-purpose entity” and changes the requirements for derecognizing financial assets. This standard also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. This accounting standard was subsequently codified into ASC Topic 860. 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 2009, the FASB issued FAS No. 167, Amendments to FASB Interpretation No. 46(R). FAS 167, which amends FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, (FIN 46(R)). Under FASB's Codification at ASC 105-10-65-1-d, FAS No. 167 will remain authoritative until integrated into the FASB Codification. This statement prescribes a qualitative model for identifying whether a company has a controlling financial interest in a variable interest entity (VIE) and eliminates the quantitative model prescribed by FIN 46(R). The new model identifies two primary characteristics of a controlling financial interest: (1) provides a company with the power to direct significant activities of the VIE, and (2) obligates a company to absorb losses of and/or provides rights to receive benefits from the VIE. FAS No. 167 requires a company to reassess on an ongoing basis whether it holds a controlling financial interest in a VIE. A company that holds a controlling financial interest is deemed to be the primary beneficiary of the VIE and is required to consolidate the VIE. This statement is effective for fiscal years beginning after November 15, 2009, and interim periods within those fiscal years. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In August 2009, the FASB issued ASU No. 2009-05, Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value. This ASU provides amendments for fair value measurements of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more techniques. ASU 2009-05 also clarifies that when estimating a fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance or fourth quarter 2009. The Company is currently evaluating the impact of this standard on the Company's financial condition, results of operations, and disclosures.

#### Note 8 – 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.

#### Note 9 - Subsequent Events

The Company assessed events occurring subsequent to September 30, 2009 through November 12, 2009 for potential recognition and disclosure in the consolidated financial statements. No events have occurred that would require adjustment to or disclosure in the consolidated financial statements which were issued on November 12, 2009.

## 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 and nine months ended September 30, 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 September 30, 2009 and December 31, 2008, the Trust Department had \$83.2 and \$74.3 million of assets under management, respectively. The \$8.9 million increase is primarily attributable to a recovery in market values of trust assets since the end of last 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 as a component of non-interest income in the Consolidated Statement of Income.

## Results of Operations

### Overview of the Income Statement

The Company had net income of \$7,206,000 for the first nine months of 2009 compared to earnings of \$3,415,000 for last year's comparable period, an increase of \$3,791,000 or 111.0%. Earnings per share for the first nine months of 2009 were \$2.51, compared to \$1.19 last year, representing a 110.9% increase. Annualized return on assets and return on equity for the nine months of 2009 were 1.39% and 17.46%, respectively, compared with 0.76% and 8.93% for last year's comparable period.

Net income for the three month's ended September 30, 2009 was \$2,388,000 compared to a net loss of \$1,052,000 in the comparable 2008 period, an increase of \$3,440,000. Earnings (loss) per share for the three months ended September 30, 2009 and 2008 were \$0.83 and \$(0.37) per share, respectively. Annualized return on assets and return on equity for the quarter ended September 30, 2009 was 1.35% and 16.84%, respectively, compared with -0.69% and -8.01% for the same 2008 period.

The comparison to last year's results is significantly impacted by the \$4.1 million other than temporary impairment charge recorded in the third quarter of last year related to investments in Freddie Mac preferred stock and a Lehman Brothers corporate bond. The after tax impact for the three months and nine months ended September 30, 2008 was approximately \$3.5 million. As a result of the Emergency Economic Stabilization Act of 2008 (EESA) being signed into law on October 3, 2008, a provision in the new bill allowed the Freddie Mac preferred stock to be treated as an ordinary loss, allowing a tax benefit of approximately \$1,000,000. However, since the EESA was not signed until after September 30, 2008, accounting rules did not allow us to recognize the \$1,000,000 tax benefit until the fourth quarter of 2008. As such, the after-tax impact for 2008 earnings was approximately \$2.5 million, after recognition in the fourth quarter of 2008 for the additional tax benefit.

### 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 nine months of 2009 was \$18,819,000, an increase of \$1,618,000, or 9.4%, compared to the same period in 2008. For the first nine months of 2009, the provision for loan losses totaled \$700,000, an increase of \$475,000 over the comparable period in 2008. Consequently, net interest income after the provision for loan losses was \$18,119,000 compared to \$16,976,000 during the first nine months of 2008.

For the three months ended September 30, 2009, net interest income was \$6,390,000 compared to \$5,963,000, an increase of \$427,000, or 7.2% over the comparable period in 2008. The provision for loan losses this quarter was \$400,000 compared to \$105,000 last year. Consequently, net interest income after the provision for loan losses was \$5,990,000 for the quarter ended compared to \$5,858,000 in 2008.

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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 nine months and three months ended September 30, 2009 and 2008:

| (dollars in thousands)                          | Analysis of Average Balances and Interest Rates (1) |          |                 |                        |          |                 |  |
|---|---|----------|-----------------|------------------------|----------|-----------------|--|
|   | Nine Months Ended                                   |          |                 |                        |          |                 |  |
|   | September 30, 2009                                  |          |                 | September 30, 2008     |          |                 |  |
|   | Average<br>Balance (1)                              | Interest | Average<br>Rate | Average<br>Balance (1) | Interest | Average<br>Rate |  |
|   | \$  | \$       | %               | \$                     | \$       | %               |  |
| <b>ASSETS</b>                                   |   |          |                 |                        |          |                 |  |
| Short-term investments:                         |   |          |                 |                        |          |                 |  |
| Interest-bearing deposits<br>at banks           | 19,894  | 27       | 0.18            | 2,543                  | 34       | 1.79            |  |
| Total short-term<br>investments                 | 19,894  | 27       | 0.18            | 2,543                  | 34       | 1.79            |  |
| Investment securities:                          |   |          |                 |                        |          |                 |  |
| Taxable   | 131,218   | 4,668    | 4.74            | 94,719                 | 3,571    | 5.03            |  |
| Tax-exempt (3)                                  | 49,726  | 2,398    | 6.43            | 34,356                 | 1,588    | 6.16            |  |
| Total investment<br>securities                  | 180,944   | 7,066    | 5.21            | 129,075                | 5,159    | 5.33            |  |
| Loans:  |   |          |                 |                        |          |                 |  |
| Residential mortgage<br>loans                   | 204,144   | 11,112   | 7.28            | 212,161                | 11,798   | 7.43            |  |
| Commercial & farm loans                         | 178,301   | 9,284    | 6.96            | 156,134                | 8,971    | 7.67            |  |
| Loans to state & political<br>subdivisions      | 46,439  | 2,144    | 6.17            | 47,568                 | 2,240    | 6.29            |  |
| Other loans                                     | 11,436  | 761      | 8.89            | 11,981                 | 818      | 9.12            |  |
| Loans, net of discount<br>(2)(3)(4)             | 440,320   | 23,301   | 7.08            | 427,844                | 23,827   | 7.44            |  |
| Total interest-earning assets                   | 641,158   | 30,394   | 6.34            | 559,462                | 29,020   | 6.93            |  |
| Cash and due from banks                         | 9,476   |          |                 | 9,576                  |          |                 |  |
| Bank premises and<br>equipment                  | 11,813  |          |                 | 12,385                 |          |                 |  |
| Other assets                                    | 27,496  |          |                 | 19,193                 |          |                 |  |
| Total non-interest earning<br>assets            | 48,785  |          |                 | 41,154                 |          |                 |  |
| Total assets                                    | 689,943   |          |                 | 600,616                |          |                 |  |
| <b>LIABILITIES AND STOCKHOLDERS'<br/>EQUITY</b> |   |          |                 |                        |          |                 |  |
| Interest-bearing liabilities:                   |   |          |                 |                        |          |                 |  |
| NOW accounts                                    | 120,999   | 732      | 0.81            | 104,866                | 1,037    | 1.32            |  |
| Savings accounts                                | 46,216  | 110      | 0.32            | 40,717                 | 114      | 0.37            |  |
| Money market accounts                           | 41,513  | 262      | 0.84            | 45,350                 | 681      | 2.01            |  |
| Certificates of deposit                         | 302,617   | 7,450    | 3.29            | 231,081                | 6,676    | 3.86            |  |
| Total interest-bearing<br>deposits              | 511,345   | 8,554    | 2.24            | 422,014                | 8,508    | 2.69            |  |
| Other borrowed funds                            | 58,175  | 1,520    | 3.49            | 67,786                 | 2,030    | 4.00            |  |

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|  |         |        |       |         |        |       |
|--|---------|--------|-------|---------|--------|-------|
| Total interest-bearing liabilities                                     | 569,520 | 10,074 | 2.36  | 489,800 | 10,538 | 2.87  |
| Demand deposits  | 56,564  |        |       | 53,587  |        |       |
| Other liabilities  | 8,830   |        |       | 6,233   |        |       |
| Total non-interest-bearing liabilities                                 | 65,394  |        |       | 59,820  |        |       |
| Stockholders' equity   | 55,029  |        |       | 50,996  |        |       |
| Total liabilities & stockholders' equity                               | 689,943 |        |       | 600,616 |        |       |
| Net interest income  |         | 20,320 |       |         | 18,482 |       |
| Net interest spread (5)  |         |        | 3.97% |         |        | 4.06% |
| Net interest income as a percentage of average interest-earning assets |         |        | 4.24% |         |        | 4.41% |
| Ratio of interest-earning assets to interest-bearing liabilities       |         |        | 1.13  |         |        | 1.14  |

(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.



Analysis of Average Balances and Interest Rates (1)  
Three Months Ended

|   | September 30, 2009     |          |                 | September 30, 2008        |          |                 |
|---|------------------------|----------|-----------------|---------------------------|----------|-----------------|
|   | Average<br>Balance (1) | Interest | Average<br>Rate | Average<br>Balance<br>(1) | Interest | Average<br>Rate |
| (dollars in thousands)                      | \$                     | \$       | %               | \$                        | \$       | %               |
| <b>ASSETS</b>                               |                        |          |                 |                           |          |                 |
| <b>Short-term investments:</b>              |                        |          |                 |                           |          |                 |
| Interest-bearing deposits at banks          | 22,956                 | 15       | 0.27            | 6,173                     | 27       | 1.74            |
| Total short-term investments                | 22,956                 | 15       | 0.27            | 6,173                     | 27       | 1.74            |
| <b>Investment securities:</b>               |                        |          |                 |                           |          |                 |
| Taxable                                     | 135,243                | 1,473    | 4.36            | 96,360                    | 1,162    | 4.82            |
| Tax-exempt (3)                              | 55,926                 | 905      | 6.47            | 35,324                    | 545      | 6.17            |
| Total investment securities                 | 191,169                | 2,378    | 4.98            | 131,684                   | 1,707    | 5.19            |
| <b>Loans:</b>                               |                        |          |                 |                           |          |                 |
| Residential mortgage loans                  | 201,992                | 3,649    | 7.17            | 211,252                   | 3,939    | 7.42            |
| Commercial & farm loans                     | 185,403                | 3,191    | 6.83            | 158,404                   | 3,071    | 7.71            |
| Loans to state & political subdivisions     | 46,472                 | 706      | 6.03            | 48,915                    | 768      | 6.25            |
| Other loans                                 | 11,751                 | 260      | 8.74            | 11,539                    | 266      | 9.17            |
| Loans, net of discount (2)(3)(4)            | 445,618                | 7,806    | 6.95            | 430,110                   | 8,044    | 7.44            |
| Total interest-earning assets               | 659,743                | 10,199   | 6.13            | 567,967                   | 9,778    | 6.85            |
| Cash and due from banks                     | 9,067                  |          |                 | 10,423                    |          |                 |
| Bank premises and equipment                 | 11,896                 |          |                 | 12,283                    |          |                 |
| Other assets                                | 27,533                 |          |                 | 19,653                    |          |                 |
| Total non-interest earning assets           | 48,496                 |          |                 | 42,359                    |          |                 |
| Total assets                                | 708,239                |          |                 | 610,326                   |          |                 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                        |          |                 |                           |          |                 |
| <b>Interest-bearing liabilities:</b>        |                        |          |                 |                           |          |                 |
| NOW accounts                                | 123,265                | 234      | 0.75            | 110,434                   | 327      | 1.18            |
| Savings accounts                            | 47,609                 | 37       | 0.31            | 42,602                    | 41       | 0.38            |
| Money market accounts                       | 41,996                 | 78       | 0.74            | 43,714                    | 186      | 1.69            |
| Certificates of deposit                     | 312,898                | 2,427    | 3.08            | 244,496                   | 2,283    | 3.71            |
| Total interest-bearing deposits             | 525,768                | 2,776    | 2.09            | 441,246                   | 2,837    | 2.56            |
| Other borrowed funds                        | 58,959                 | 501      | 3.37            | 53,221                    | 545      | 4.07            |
| Total interest-bearing liabilities          | 584,727                | 3,277    | 2.22            | 494,467                   | 3,382    | 2.72            |
| Demand deposits                             | 58,080                 |          |                 | 56,715                    |          |                 |
| Other liabilities                           | 8,697                  |          |                 | 6,566                     |          |                 |
| Total non-interest-bearing                  | 66,777                 |          |                 | 63,281                    |          |                 |

|  |         |       |         |       |
|--|---------|-------|---------|-------|
| liabilities  |         |       |         |       |
| Stockholders' equity   | 56,735  |       | 52,578  |       |
| Total liabilities & stockholders' equity                               | 708,239 |       | 610,326 |       |
| Net interest income  |         | 6,922 |         | 6,396 |
| Net interest spread (5)  |         |       | 3.91%   | 4.13% |
| Net interest income as a percentage of average interest-earning assets |         |       | 4.16%   | 4.48% |
| Ratio of interest-earning assets to interest-bearing liabilities       |         |       | 1.13    | 1.15  |

(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

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 September 30, 2009 and 2008:

| (dollars in thousands)  | For the Three Months<br>Ended September 30 |          | For the Nine Months<br>Ended September 30 |           |
|---|--|----------|---|-----------|
|   | 2009                                       | 2008     | 2009                                      | 2008      |
| Interest and dividend income from investment securities   |  |          |   |           |
| and interest bearing deposits at banks (non-tax adjusted)   | \$ 2,086                                   | \$ 1,552 | \$ 6,277                                  | \$ 4,637  |
| Tax equivalent adjustment   | 307  | 182      | 816                                       | 556       |
| Interest and dividend income from investment securities and interest bearing deposits at banks (tax equivalent basis) | \$ 2,393                                   | \$ 1,734 | \$ 7,093                                  | \$ 5,193  |
| Interest and fees on loans (non-tax adjusted)   | \$ 7,581                                   | \$ 7,793 | \$ 22,616                                 | \$ 23,102 |
| Tax equivalent adjustment   | 225  | 251      | 685                                       | 725       |
| Interest and fees on loans (tax equivalent basis)   | \$ 7,806                                   | \$ 8,044 | \$ 23,301                                 | \$ 23,827 |
| Total interest income   | \$ 9,667                                   | \$ 9,345 | \$ 28,893                                 | \$ 27,739 |
| Total interest expense  | 3,277                                      | 3,382    | 10,074                                    | 10,538    |
| Net interest income   | 6,390                                      | 5,963    | 18,819                                    | 17,201    |
| Total tax equivalent adjustment   | 532  | 433      | 1,501                                     | 1,281     |
| Net interest income (tax equivalent basis)  | \$ 6,922                                   | \$ 6,396 | \$ 20,320                                 | \$ 18,482 |

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

Analysis of Changes in Net Interest Income on a Tax-Equivalent Basis (1)

| (in thousands)                          | Three months ended September 30, 2009 vs. 2008 (1) |                |               | Nine months ended September 30, 2009 vs. 2008 (1) |                |                 |
|---|--|----------------|---------------|---|----------------|-----------------|
|   | Change in Volume                                   | Change in Rate | Total Change  | Change in Volume                                  | Change in Rate | Total Change    |
| <b>Interest Income:</b>                 |  |                |               |   |                |                 |
| <b>Short-term investments:</b>          |  |                |               |   |                |                 |
| <b>Interest-bearing deposits</b>        |  |                |               |   |                |                 |
| at banks                                | \$ 26  | \$ (38)        | \$ (12)       | \$ (8)  | \$ 1           | \$ (7)          |
| <b>Investment securities:</b>           |  |                |               |   |                |                 |
| Taxable                                 | 432  | (121)          | 311           | 1,285   | (188)          | 1,097           |
| Tax-exempt                              | 335  | 25             | 360           | 738   | 72             | 810             |
| <b>Total investments</b>                | <b>767</b>   | <b>(96)</b>    | <b>671</b>    | <b>2,023</b>                                      | <b>(116)</b>   | <b>1,907</b>    |
| <b>Loans:</b>                           |  |                |               |   |                |                 |
| Residential mortgage loans              | (137)  | (153)          | (290)         | (451)   | (235)          | (686)           |
| Commercial & farm loans                 | 497  | (377)          | 120           | 922   | (609)          | 313             |
| Loans to state & political subdivisions | (32)   | (30)           | (62)          | (54)  | (42)           | (96)            |
| Other loans                             | 6  | (12)           | (6)           | (37)  | (20)           | (57)            |
| <b>Total loans, net of discount</b>     | <b>334</b>   | <b>(572)</b>   | <b>(238)</b>  | <b>380</b>  | <b>(906)</b>   | <b>(526)</b>    |
| <b>Total Interest Income</b>            | <b>1,127</b>                                       | <b>(706)</b>   | <b>421</b>    | <b>2,395</b>                                      | <b>(1,021)</b> | <b>1,374</b>    |
| <b>Interest Expense:</b>                |  |                |               |   |                |                 |
| <b>Interest-bearing deposits:</b>       |  |                |               |   |                |                 |
| NOW accounts                            | 36   | (129)          | (93)          | 200   | (505)          | (305)           |
| Savings accounts                        | 5  | (9)            | (4)           | 39  | (43)           | (4)             |
| Money Market accounts                   | (7)  | (101)          | (108)         | (54)  | (365)          | (419)           |
| Certificates of deposit                 | 578  | (434)          | 144           | 1,480   | (706)          | 774             |
| <b>Total interest-bearing deposits</b>  | <b>612</b>   | <b>(673)</b>   | <b>(61)</b>   | <b>1,665</b>                                      | <b>(1,619)</b> | <b>46</b>       |
| Other borrowed funds                    | 56   | (100)          | (44)          | (270)   | (240)          | (510)           |
| <b>Total interest expense</b>           | <b>668</b>   | <b>(773)</b>   | <b>(105)</b>  | <b>1,395</b>                                      | <b>(1,859)</b> | <b>(464)</b>    |
| <b>Net interest income</b>              | <b>\$ 459</b>                                      | <b>\$ 67</b>   | <b>\$ 526</b> | <b>\$ 1,000</b>                                   | <b>\$ 838</b>  | <b>\$ 1,838</b> |

(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 increased from \$18,482,000 for the 2008 nine month period to \$20,320,000 in the 2009 nine month period, an increase of \$1,838,000 for the nine months ended September 30, 2009. The tax equivalent net interest margin decreased from 4.41% for the first nine months of 2008 to 4.24% in 2009.

Total interest income for the nine month periods increased \$1,374,000. This increase is primarily a result of a \$2,395,000 increase due to volume as the average balance of interest earning assets increased by \$81.7 million. There was a decrease of \$1,021,000 due to change in rate, as the yield on interest earning assets decreased 59 basis points from 6.93% to 6.34%. Investment income for the nine months ended September 30, 2009 increased \$1,907,000 over the same period last year. The average balance of total investment securities at September 30, 2009 increased by \$51.9 million from December 31, 2009 due to investment opportunities and investing excess cash, primarily the result of increased deposits. The average balance of taxable securities increased by \$36.5 million while tax-exempt securities increased by \$15.4 million, which had the effect of increasing interest income by \$1,285,000 and \$738,000, 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 \$526,000 for the nine months ended September 30, 2009 compared to the same period last year. Interest income on residential mortgage loans decreased \$686,000 of which \$451,000 was due to volume and \$235,000 was 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. The average balance of commercial and farm loans increased \$22.2 million from a year ago primarily due to our emphasis to grow this segment of the loan portfolio. This had a positive impact of \$922,000 on total interest income due to volume. Offsetting this, a decrease of 71 basis points earned on commercial and farm loans had the effect of decreasing interest income by \$609,000.

Total interest expense decreased \$464,000 for the nine months ended September 30, 2009 compared with last year. This decrease is primarily due to a change in rate, accounting for a \$1,859,000 decrease in our interest expense. The average interest rate on interest-bearing liabilities decreased 51 basis points, from 2.87% to 2.36%. 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 \$79.7 million resulting in an increase in interest expense of \$1,395,000 (see also "Financial Condition – Deposits"). The average balance of certificates of deposit increased \$71.5 million causing an increase in interest expense of \$1,480,000. Offsetting the increase in average balance was a decrease in the rate on certificates of deposit from 3.86% to 3.29% resulting in a decrease of \$706,000. The average balance of NOW accounts also increased \$16.1 million accounting for an increase of \$200,000 in interest expense. The change in rate from 132 basis points to 81 basis points, contributed to an offset in interest expense of \$505,000 resulting in an overall decrease of \$305,000. The average balance of borrowed funds decreased by \$9.6 million resulting in a decrease in interest expense of \$270,000. The average interest rate paid on borrowed funds also decreased by 51 basis points accounting for a decrease in interest expense of \$240,000 due to rate.

Tax equivalent net interest income for the three months ended September 30, 2009 was \$6,922,000 which compares to \$6,396,000 for the same period last year. This represents an increase of \$526,000 or 8.2%. Total tax equivalent interest income was \$10,199,000 compared with \$9,778,000 for the comparable period last year, an increase of \$421,000. Of this amount, \$1,127,000 was due to an increase in volume and \$706,000 was due to a decrease in rate. Total investment income increased by \$671,000 compared to last year. This was predominantly due to a change in volume of \$59.5 million in investment securities. Total interest expense decreased \$105,000 for the three months ended September 30, 2009 compared with last year. \$668,000 is attributable to an increase in volume mostly due to a \$68.4 million increase in certificates of deposit. Conversely, \$773,000 is due to a decrease in rate as the average rate on interest-bearing liabilities decreased 50 basis points from 2.72% to 2.22%.

#### Provision For Loan Losses

For the nine-month period ending September 30, 2009, we recorded a provision for loan losses of \$700,000, which represents an increase of \$475,000 over the same time period in 2008. This is the result of current economic conditions and an increase in non-performing loans as of September 30, 2009, which have impacted management's quarterly review of the allowance for loan losses. The quarterly review 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, actual and expected loan growth and peer comparisons (see also "Financial Condition – Allowance for Loan Losses").

For the three months ending September 30, 2009, we recorded a provision of \$400,000 compared to \$105,000 in 2008.

#### Non-interest Income

Non-interest income for the nine months ended September 30, 2009 totaled \$4,341,000, an increase of \$4,538,000 when compared to the same period in 2008. \$4,207,000 of the increase is attributable primarily to the investment securities losses recorded in the third quarter of 2008 related to other than temporary impairment charges on Freddie Mac preferred stock and a Lehman Brothers corporate bond. During the first nine months of 2009, investment securities gains amounted to \$118,000. We sold an agency bond at a gain of \$32,000 that was likely to be called in 2009. We also elected to sell several higher coupon mortgage-backed securities that were prepaying very quickly realizing total gains of \$157,000. This was offset with a \$16,000 loss on the sale of bank equity shares as well as an

other than temporary impairment charge of \$54,000 on our Freddie Mac preferred stock.

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Service charge income increased by \$73,000 and continues to be the Company's primary source of non-interest income. For the first nine months of 2009, account service charges totaled \$2,664,000 compared to \$2,591,000 last year. Approximately \$42,000 of the increase is attributable to customers' usage of their debit cards, \$19,000 is due to an increase in fees charged to customers for non-sufficient funds, and an additional \$15,000 is due to an increase in statement service charges.

Brokerage and insurance income increased \$52,000 as we continue to increase the principal amounts invested through us by our customers. We continue to grow and develop this segment of business with our customers. Gains on loans sold also increased \$247,000 compared to last year as a result of the amount of refinancing due to favorable rates in the secondary markets during the economic downturn. Earnings on bank owned life insurance (BOLI) increased from \$261,000 in 2008 to \$364,000 for the nine months ended September 30, 2009. In the fourth quarter of 2008, we invested an additional \$3.4 million based upon an analysis of new employees and updated future employee benefit costs, resulting in additional BOLI income. Trust income is down slightly by \$54,000 through nine months compared to 2008 due to the economy's downturn and the affect it has had on the values of trust assets under management for most of 2009.

For reasons previously mentioned above, service charges increased by \$14,000 for the three months ended September 30, 2009 compared to the same period in 2008. Gains on loans sold increased by \$79,000 compared to last year's three months ended due to significantly higher refinancing activity in the secondary market. Investment securities gains amounted to \$0 for the quarter compared to a loss of \$4,089,000 last year. Earnings on bank owned life insurance also increased \$38,000 for the quarter ended September 30, 2009 compared to 2008 due to the increase in the BOLI investment. Brokerage and insurance increased \$17,000 for the comparable period mainly due to some recent activity done in 2009. Trust income, as mentioned above, declined by \$27,000 comparing the last three months to the comparable 2008 period.

The following table shows the breakdown of non-interest income for the three and nine months ended September 30, 2009 and 2008:

|   | Nine months ended September 30, |          |          | Change    |  |
|---|---------------------------------|----------|----------|-----------|--|
|   | 2009                            | 2008     | Amount   | %         |  |
| Service charges                           | \$ 2,664                        | \$ 2,591 | \$ 73    | 2.8       |  |
| Trust                                     | 397                             | 451      | (54)     | (12.0)    |  |
| Brokerage and insurance                   | 228                             | 176      | 52       | 29.5      |  |
| Gains on loans sold                       | 292                             | 45       | 247      | 548.9     |  |
| Investment securities gains (losses), net | 118                             | (4,089)  | 4,207    | -         |  |
| Earnings on bank owned life insurance     | 364                             | 261      | 103      | 39.5      |  |
| Other                                     | 278                             | 368      | (90)     | (24.5)    |  |
| Total                                     | \$ 4,341                        | \$ (197) | \$ 4,538 | (2,303.6) |  |

|                                       | Three months ended September 30, |         |        | Change  |  |
|---------------------------------------|----------------------------------|---------|--------|---------|--|
|                                       | 2009                             | 2008    | Amount | %       |  |
| Service charges                       | \$ 958                           | \$ 944  | \$ 14  | 1.5     |  |
| Trust                                 | 121                              | 148     | (27)   | (18.2)  |  |
| Brokerage and insurance               | 75                               | 58      | 17     | 29.3    |  |
| Gains on loans sold                   | 83                               | 4       | 79     | 1,975.0 |  |
| Investment securities losses, net     | -                                | (4,089) | 4,089  | -       |  |
| Earnings on bank owned life insurance | 128                              | 90      | 38     | 42.2    |  |
| Other                                 | 87                               | 121     | (34)   | (28.1)  |  |



|       |    |       |    |         |    |       |         |
|-------|----|-------|----|---------|----|-------|---------|
| Total | \$ | 1,452 | \$ | (2,724) | \$ | 4,176 | (153.3) |
|-------|----|-------|----|---------|----|-------|---------|

## Non-interest Expense

Non-interest expenses increased \$1,428,000 or 12.0%, through September 30, 2009 compared to the same period in 2008. The increase in salaries and employee benefits of \$508,000 is due mainly to annual merit increases, increased employee insurance premiums, pension expenses and the implementation of a Supplemental Executive Retirement Plan (SERP) late in 2008.

FDIC Insurance increased by \$926,000 for the nine months ended September 30, 2009 primarily due to an increase in our FDIC deposit insurance assessments. Through the first nine months of this year, we have expensed \$1,030,000 for FDIC assessments compared to only \$104,000 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 related to the continuing failing of many banks across the nation, the FDIC increased their rates and charged a five basis point special assessment based on assets as of June 30, 2009. The impact of this special assessment was approximately \$325,000. In lieu of an additional special assessment in the fourth quarter of 2009, the FDIC has announced that they will require assessments for the following three years, 2010 – 2012, be prepaid in order to increase the monies available in the insurance fund. These prepayments will be recognized as a charge to operations over the applicable three year period.

Professional fees decreased \$26,000 due to non-recurring costs in 2008 surrounding branch expansion activities. The \$32,000 decrease in furniture and equipment is due to assets becoming fully depreciated.

For the three months ended, September 30, 2009, salaries and employee benefits increased by \$197,000 due to merit increases, higher employee insurance premiums, increased pension expense and SERP benefits. As mentioned above, FDIC insurance also increased by \$225,000 compared to the same period last year.

The following tables reflect the breakdown of non-interest expense and professional fees for the three and nine months ended September 30, 2009 and 2008:

|                                | Nine months ended September 30, |        |        | Change |    |       |       |
|--------------------------------|---------------------------------|--------|--------|--------|----|-------|-------|
|                                | 2009                            | 2008   | Amount | %      |    |       |       |
| Salaries and employee benefits | \$                              | 7,018  | \$     | 6,510  | \$ | 508   | 7.8   |
| Occupancy                      |                                 | 889    |        | 866    |    | 23    | 2.7   |
| Furniture and equipment        |                                 | 336    |        | 368    |    | (32)  | (8.7) |
| Professional fees              |                                 | 459    |        | 485    |    | (26)  | (5.4) |
| FDIC Insurance                 |                                 | 1,030  |        | 104    |    | 926   | 890.4 |
| Other                          |                                 | 3,581  |        | 3,552  |    | 29    | 0.8   |
| Total                          | \$                              | 13,313 | \$     | 11,885 | \$ | 1,428 | 12.0  |

|                         | Nine months ended September 30, |      |        | Change |    |      |        |
|-------------------------|---------------------------------|------|--------|--------|----|------|--------|
|                         | 2009                            | 2008 | Amount | %      |    |      |        |
| Other professional fees | \$                              | 215  | \$     | 245    | \$ | (30) | (12.2) |
| Legal fees              |                                 | 70   |        | 89     |    | (19) | (21.3) |
| Examinations and audits |                                 | 174  |        | 151    |    | 23   | 15.2   |
| Total                   | \$                              | 459  | \$     | 485    | \$ | (26) | (5.4)  |

|                                | Three months ended September 30, |          | Change |       |
|--------------------------------|----------------------------------|----------|--------|-------|
|                                | 2009                             | 2008     | Amount | %     |
| Salaries and employee benefits | \$ 2,393                         | \$ 2,196 | \$ 197 | 9.0   |
| Occupancy                      | 272                              | 271      | 1      | 0.4   |
| Furniture and equipment        | 102                              | 107      | (5)    | (4.7) |
| Professional fees              | 164                              | 156      | 8      | 5.1   |
| FDIC Insurance                 | 277                              | 52       | 225    | 432.7 |
| Other                          | 1,242                            | 1,250    | (8)    | (0.6) |
| Total                          | \$ 4,450                         | \$ 4,032 | \$ 418 | 10.4  |

|                         | Three months ended September 30, |        | Change |        |
|-------------------------|----------------------------------|--------|--------|--------|
|                         | 2009                             | 2008   | Amount | %      |
| Other professional fees | \$ 69                            | \$ 67  | \$ 2   | 3.0    |
| Legal fees              | 33                               | 42     | (9)    | (21.4) |
| Examinations and audits | 62                               | 47     | 15     | 31.9   |
| Total                   | \$ 164                           | \$ 156 | \$ 8   | 5.1    |

#### Provision For Income Taxes

The provision for income taxes was \$1,941,000 for the nine-month period ended September 30, 2009 compared to \$1,479,000 for the same period in 2008. The increase is attributable to an increase in income before provision for income taxes of \$4,253,000 and primarily due to a decrease in our effective tax rate compared to last year. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 21.2% and 30.2% for the first nine months of 2009 and 2008, respectively, compared to the statutory rate of 34%. Our effective tax rate in 2008 was attributable to the accounting treatment required on the write-down of our Freddie Mac Preferred stock recorded in the third quarter of 2008.

For the three-months ended September 30, 2009 the provision for income taxes was \$604,000, resulting in an effective tax rate of 20.2%. This compares to a provision for income taxes of \$154,000 for the comparable period last year, which was primarily impacted by the accounting treatment required on the write-down of the Freddie Mac preferred stock.

We invest 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 \$822,000 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 \$298,000 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 \$158,000 out of a total \$574,000 of tax credits. We anticipate recognizing \$594,000 of tax credits over the next eight years.

#### Financial Condition

Total assets were \$707.2 million at September 30, 2009, an increase of \$38.6 million, or 5.8% from \$668.6 million at December 31, 2008. Net loans increased 3.6% to \$443.8 million and investment securities increased 13.4% to \$197.5 million at September 30, 2009. Total deposits increased \$33.2 million or 6.1% to \$579.8 million since year-end 2008. Borrowed funds have decreased \$3.4 million to \$57.8 million compared with \$61.2 million at year-end.



## Cash and Cash Equivalents

Cash and cash equivalents totaled \$20.2 million at September 30, 2009 compared to \$19.9 million at December 31, 2008, an increase of \$.3 million. Non-interest-bearing cash increased \$1.2 million since year-end 2008, while interest-bearing cash decreased \$.9 million during that same period. The increase in deposits has had a direct correlation to the increase in cash and cash equivalents and has contributed greatly in strengthening our liquidity position during this recessionary period. We believe the liquidity needs of the Company are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, and the portion of the investment and loan portfolios that mature within one year. These sources of funds will enable the Company to meet cash obligations and off-balance sheet commitments as they come due.

## Investments

Our investment portfolio increased by \$23.4 million or 13.4% from December 31, 2008 to September 30, 2009. During 2009 we purchased approximately \$37.7 million of U.S. agency obligations, \$7.4 million of mortgage backed securities and \$15.4 million of state and local obligations which help offset the \$23.4 million of principal repayments and \$11.7 million of calls that occurred during the year. We also selectively sold \$6.8 million of bonds and equities at a net gain of \$118,000. The overall market value of our investment portfolio increased approximately \$4.9 million due to market fluctuations since year end. Significant market recoveries were seen in our mortgage backed securities, state and local obligations, and our corporate bonds since year end. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio is currently yielding 5.21% compared to 5.33% a year ago on a tax equivalent basis.

As mentioned above, due to the economic downturn and the lowering of interest rates, we have experienced significant prepayments of our mortgage backed securities and calls on our agency bonds. Due to the amount of cash flow from the investment portfolio as well as an increase in deposits, our strategy has been to reinvest funds mainly in short-term agency bonds and longer-term municipal bonds.

## Estimated Fair Market Value of Investment Portfolio

| (dollars in thousands)                        | September 30, 2009 |       | December 31, 2008 |       |
|---|--------------------|-------|-------------------|-------|
|   | Amount             | %     | Amount            | %     |
| Available-for-sale:                           |                    |       |                   |       |
| U. S. Agency securities                       | \$ 53,931          | 27.3  | \$ 28,942         | 16.6  |
| Obligations of state & political subdivisions | 60,847             | 30.8  | 44,132            | 25.3  |
| Corporate obligations                         | 6,138              | 3.1   | 5,296             | 3.0   |
| Mortgage-backed securities                    | 76,068             | 38.5  | 95,407            | 54.8  |
| Equity securities                             | 560                | 0.3   | 362               | 0.3   |
| Total   | \$ 197,544         | 100.0 | \$ 174,139        | 100.0 |

September 30, 2009/  
December 31, 2008  
Change

| (dollars in thousands)           | Amount    | %    |
|----------------------------------|-----------|------|
| Available-for-sale:              |           |      |
| U. S. Agency securities          | \$ 24,989 | 86.3 |
| Obligations of state & political |           |      |

|                            |           |        |
|----------------------------|-----------|--------|
| subdivisions               | 16,715    | 37.9   |
| Corporate obligations      | 842       | 15.9   |
| Mortgage-backed securities | (19,339)  | (20.3) |
| Equity securities          | 198       | 54.7   |
| Total                      | \$ 23,405 | 13.4   |

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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 \$15.7 million or 3.6% during the first nine months of 2009. Commercial real estate, agricultural, and commercial and other loans increased \$20.0 million, \$2.0 million and \$3.7 million, respectively. Residential real estate, construction, and municipal loans have decreased \$2.4 million, \$6.2 million, and \$1.7 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, higher unemployment, and a depressed housing market have had a negative impact on nonconforming, residential real estate mortgage and home equity loan growth. Conversely, loan demand for conforming mortgages, which the Company sells on the secondary market, has increased dramatically during the first nine months of 2009. Through September 30, 2009, we have sold \$17.5 million of loans in the secondary market compared to just \$3.8 million through this time last year. 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 recession, reflects the Company's focus on commercial lending as a means to increase loan growth and obtain deposits from farmers and small businesses throughout our market area. We believe we have a strong team of experienced professionals that enable us to meet the needs of these customers within our service area.

| (in thousands)                            | September 30,<br>2009 |       | December 31,<br>2008 |       |
|---|-----------------------|-------|----------------------|-------|
|   | Amount                | %     | Amount               | %     |
| Real estate:                              |                       |       |                      |       |
| Residential                               | \$ 196,709            | 43.8  | \$ 199,118           | 46.0  |
| Commercial                                | 127,697               | 28.5  | 107,740              | 24.9  |
| Agricultural                              | 19,017                | 4.2   | 17,066               | 3.9   |
| Construction                              | 4,944                 | 1.1   | 11,118               | 2.6   |
| Loans to individuals                      |                       |       |                      |       |
| for household, family and other purchases | 12,012                | 2.7   | 11,651               | 2.7   |
| Commercial and other loans                | 41,666                | 9.3   | 37,968               | 8.8   |
| State & political subdivision loans       | 46,446                | 10.4  | 48,153               | 11.1  |
| Total loans                               | 448,491               | 100.0 | 432,814              | 100.0 |
| Less allowance for loan losses            | 4,683                 |       | 4,378                |       |
| Net loans                                 | \$ 443,808            |       | \$ 428,436           |       |

September 30, 2009/  
December 31, 2008  
Change

| (in thousands)                      | Amount     | %      |
|-------------------------------------|------------|--------|
| Real estate:                        |            |        |
| Residential                         | \$ (2,409) | (1.2)  |
| Commercial                          | 19,957     | 18.5   |
| Agricultural                        | 1,951      | 11.4   |
| Construction                        | (6,174)    | (55.5) |
| Loans to individuals                |            |        |
| for household, family and other     |            |        |
| purchases                           | 361        | 3.1    |
| Commercial and other loans          | 3,698      | 9.7    |
| State & political subdivision loans | (1,707)    | (3.5)  |
| Total loans                         | \$ 15,677  | 3.6    |



## Allowance For Loan Losses

The allowance for loan losses as a percentage of loans increased from 1.01% at December 31, 2008 to 1.04% at September 30, 2009. The allowance increased \$305,000 since year-end 2008. The increase is a result of a \$700,000 provision for the first nine months less net charge-offs. Gross charge-offs for the first nine months of 2009 were \$486,000, while recoveries were \$91,000. Due to the increased level of charged-off loans, the increase in non-performing loans, management has increased the provision for loan losses compared to the same period a year ago.

| (in thousands)  | September 30,<br>2009 | 2008     | 2007     | 2006     | December 31,<br>2005 |
|---|-----------------------|----------|----------|----------|----------------------|
| Balance, at beginning of period                                   | \$ 4,378              | \$ 4,197 | \$ 3,876 | \$ 3,664 | \$ 3,919             |
| Provision charged to income                                       | 700                   | 330      | 365      | 330      | 60                   |
| Recoveries on loans previously<br>charged against the allowance   | 91                    | 97       | 142      | 172      | 57                   |
|   | 5,169                 | 4,624    | 4,383    | 4,166    | 4,036                |
| Loans charged against the allowance                               | (486)                 | (246)    | (186)    | (290)    | (372)                |
| Balance, at end of year   | \$ 4,683              | \$ 4,378 | \$ 4,197 | \$ 3,876 | \$ 3,664             |
| Allowance for loan losses as a percent<br>of total loans          | 1.04%                 | 1.01%    | 0.99%    | 0.93%    | 0.96%                |
| Allowance for loan losses as a percent<br>of non-performing loans | 79.09%                | 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 September 30, 2009. The Company has disclosed in its annual report on Form 10-K for the year ended December 31, 2008 the process and methodology for determining the level of the allowance for loan losses.

## 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).

| (dollars in thousands)  | September 30,<br>2009 | 2008    | 2007    | 31,<br>2006 | December<br>2005 |
|---|-----------------------|---------|---------|-------------|------------------|
| Non-performing loans:   |                       |         |         |             |                  |
| Non-accruing loans  | \$ 5,727              | \$2,202 | \$1,915 | \$1,668     | \$1,898          |
| Accrual loans - 90 days or<br>more past due                           | 194                   | 383     | 275     | 1,690       | 337              |
| Total non-performing loans  | 5,921                 | 2,585   | 2,190   | 3,358       | 2,235            |
| Foreclosed assets held for sale                                       | 596                   | 591     | 203     | 758         | 619              |
| Total non-performing assets   | \$ 6,517              | \$3,176 | \$2,393 | \$4,116     | \$2,854          |
| Non-performing loans as a percent of loans<br>net of unearned income  | 1.32%                 | 0.60%   | 0.52%   | 0.81%       | 0.58%            |
| Non-performing assets as a percent of loans<br>net of unearned income | 1.45%                 | 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. Non-accruing loans increased at September 30, 2009 mainly due to two large commercial loans, and accounted for non-performing loans as a percent of total loans increasing from .60% at December 31, 2008 to 1.32% as of September 30, 2009. All commercial loans on non-accrual are evaluated for impairment. Based upon this evaluation, \$39,000 was specifically reserved for through our quarterly Allowance for Loan Loss calculation as of September 30, 2009.

#### Bank Owned Life Insurance

The Company purchased bank owned life insurance to offset future employee benefit costs. As of September 30, 2009 the cash surrender value of this life insurance is \$12,539,000. 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 individuals) provide partial recovery of cash outflows associated with the benefits.

#### Premises and Equipment

Premises and equipment decreased \$866,000 from \$12.8 at December 31, 2008 to \$11.9 at September 30, 2009, a decrease of 6.8%. This occurred primarily due to the sale of a banking facility for approximately \$1.4 million during the first quarter of 2009. We continue to lease and conduct business at the property. Offsetting this decrease were purchases of premises and equipment in the amount of \$1,063,000 primarily due to the new branch construction at our Troy, Pennsylvania location. As expected, in October 2009 the Company began construction of a new banking facility in our Wellsboro, Pennsylvania location. Expected construction costs are approximately \$1.1 million, with completion anticipated in the second quarter 2010.

#### Deposits

Core deposits continue to be the most significant source of funds for the Company. Deposits increased \$33.2 million or 6.1%, 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 also 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 September 30, 2009, non-interest-bearing deposits, NOW accounts, and savings accounts, have all increased by \$.5 million, \$.6.3 million, and \$.2.9 million, respectively, from December 31, 2008. Certificates of deposit also increased by \$.23.5 million. 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 significant impact on this segment as well. The Bank currently does not have any outstanding brokered certificates of deposit.

| (in thousands)                | September 30,<br>2009 |       | December 31,<br>2008 |       |
|-------------------------------|-----------------------|-------|----------------------|-------|
|                               | Amount                | %     | Amount               | %     |
| Non-interest-bearing deposits | \$ 56,071             | 9.6   | \$ 55,545            | 10.2  |
| NOW accounts                  | 121,598               | 21.0  | 115,338              | 21.1  |
| Savings deposits              | 47,303                | 8.2   | 44,447               | 8.1   |
| Money market deposit accounts | 41,817                | 7.2   | 41,752               | 7.6   |
| Certificates of deposit       | 313,058               | 54.0  | 289,598              | 53.0  |
| Total                         | \$ 579,847            | 100.0 | \$ 546,680           | 100.0 |



| (in thousands)                | September 30, 2009/<br>December 31, 2008 |     |
|-------------------------------|--|-----|
|                               | Change                                   |     |
|                               | Amount                                   | %   |
| Non-interest-bearing deposits | \$ 526                                   | 0.9 |
| NOW accounts                  | 6,260                                    | 5.4 |
| Savings deposits              | 2,856                                    | 6.4 |
| Money market deposit accounts | 65                                       | 0.2 |
| Certificates of deposit       | 23,460                                   | 8.1 |
| Total                         | \$ 33,167                                | 6.1 |

#### Borrowed Funds

Borrowed funds decreased \$3.4 million during the first nine 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 of Pittsburgh.

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 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 the above mentioned 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 September 30, 2009 was a liability of \$221,000 and is included within other liabilities on the Consolidated Balance Sheet.

#### 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 \$61.1 million at September 30, 2009 compared to \$52.8 million at December 31, 2008, an increase of \$8.3 million or 15.8%. Excluding accumulated other comprehensive income, stockholder's equity increased \$5.0 million, or 9.5%. In the first nine months of 2009, the Company had net income of \$7.2 million and paid dividends of \$2.1 million, representing a dividend payout ratio of 29.2%. The Company purchased 9,795 shares of treasury stock at a weighted average cost of \$19.57 per share. The Company also awarded 7,526 shares of restricted stock to employees and 900 shares to the Board of Directors under equity 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 \$3,339,000 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:

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| (dollars in thousands)                   |          | September 30, |          | December 31, |  |
|--|----------|---------------|----------|--------------|--|
|  |          | 2009          |          | 2008         |  |
| Total capital (to risk-weighted assets)  | Amount   | Ratio         | Amount   | Ratio        |  |
| Company                                  | \$60,733 | 13.58%        | \$54,924 | 13.06%       |  |
| For capital adequacy purposes            | 35,771   | 8.00%         | 33,652   | 8.00%        |  |
| To be well capitalized                   | 44,713   | 10.00%        | 42,065   | 10.00%       |  |
| Tier I capital (to risk-weighted assets) |          |               |          |              |  |
| Company                                  | \$55,992 | 12.52%        | \$50,546 | 12.02%       |  |
| For capital adequacy purposes            | 17,885   | 4.00%         | 16,826   | 4.00%        |  |
| To be well capitalized                   | 26,828   | 6.00%         | 25,239   | 6.00%        |  |
| Tier I capital (to average assets)       |          |               |          |              |  |
| Company                                  | \$55,992 | 8.04%         | \$50,546 | 7.91%        |  |
| For capital adequacy purposes            | 27,869   | 4.00%         | 25,547   | 4.00%        |  |
| To be well capitalized                   | 34,836   | 5.00%         | 31,934   | 5.00%        |  |

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

| (dollars in thousands)                   |          | September 30, |          | December 31, |  |
|--|----------|---------------|----------|--------------|--|
|  |          | 2009          |          | 2008         |  |
| Total capital (to risk-weighted assets)  | Amount   | Ratio         | Amount   | Ratio        |  |
| Bank                                     | \$55,108 | 12.35%        | \$49,248 | 11.73%       |  |
| For capital adequacy purposes            | 35,700   | 8.00%         | 33,593   | 8.00%        |  |
| To be well capitalized                   | 44,625   | 10.00%        | 41,991   | 10.00%       |  |
| Tier I capital (to risk-weighted assets) |          |               |          |              |  |
| Bank                                     | \$50,387 | 11.29%        | \$44,871 | 10.69%       |  |
| For capital adequacy purposes            | 17,850   | 4.00%         | 16,796   | 4.00%        |  |
| To be well capitalized                   | 26,775   | 6.00%         | 25,194   | 6.00%        |  |
| Tier I capital (to average assets)       |          |               |          |              |  |
| Bank                                     | \$50,387 | 7.24%         | \$44,871 | 7.04%        |  |
| For capital adequacy purposes            | 27,841   | 4.00%         | 25,510   | 4.00%        |  |
| To be well capitalized                   | 34,802   | 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 September 30, 2009 (dollars in thousands):

|                              |           |
|------------------------------|-----------|
| Commitments to extend credit | \$ 90,502 |
| Standby letters of credit    | 6,471     |
|                              | \$ 96,973 |





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 September 30, 2009 was \$11,196,000. 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 nine months of 2009 were \$1,063,000, compared to \$249,000 during the same time period in 2008. Our new branch construction in Troy, Pennsylvania accounted for most of this expenditure.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short-term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$260.0 million, of which \$42.0 million was outstanding at September 30, 2009. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon.

Citizens Financial is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial's primary source of income is dividends received from the Bank. The Bank may not, under the National Bank Act, declare a dividend without approval of the OCC, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. In addition, the Bank can only pay dividends to the extent that its retained net profits (including the portion transferred to surplus) exceed its bad debts. The Federal Reserve Board, the OCC and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At September 30, 2009, Citizens Financial had liquid assets of \$5.0 million.

### 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 .3% 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 third 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 nine months ended September 30, 2009 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

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## 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 September 30, 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<br>Shares (or units<br>Purchased) | Average Price<br>Paid per Share<br>(or Unit) | Total Number of<br>Shares (or Units)<br>Purchased as Part of<br>Publicly Announced<br>Plans of Programs | Maximum Number<br>(or Approximate<br>Dollar Value) of<br>Shares (or Units) that<br>May Yet Be<br>Purchased Under the<br>Plans or Programs (1) |
|-------------------|---|--|---|---|
| 7/1/09 to 7/31/09 | -   | -  | -   | 54,505  |
| 8/1/09 to 8/30/09 | -   | -  | -   | 54,505  |
| 9/1/09 to 9/30/09 | -   | -  | -   | 54,505  |
| Total             | -   | -  | -   | 54,505  |

(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

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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.

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)

November 12, 2009

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

November 12, 2009

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



