

CITIZENS FINANCIAL SERVICES INC

Form ARS

March 08, 2005

*(dollars in thousands, except per share data)***2004****2003****BALANCE SHEET**

Assets	\$	499,347	\$	463,878
Deposits		419,074		385,691
Net Loans		355,774		314,037
Investments		95,747		106,587
Stockholders' Equity		40,789		38,529

STATEMENT OF INCOME

Interest Income	26,606	25,615
Interest Expense	9,235	8,826
Net Interest Income	17,371	16,789
Net Income	5,267	4,879

PER SHARE DATA

Net Income	1.85	1.70
Cash Dividends	0.78	0.74

TRUST DEPARTMENT

Trust Assets Managed	67,459	70,384
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TO OUR SHAREHOLDERS, CUSTOMERS AND FRIENDS,

I'm honored to be writing my first Annual Report letter as CEO and President of Citizens Financial Services, Inc. and its wholly owned subsidiary, First Citizens National Bank. I'm pleased to report that thanks to the dedication and loyalty of our employees, board members and customers, we have had another outstanding year of financial performance in 2004.

A simple philosophy can lead a company to great rewards. Treat your customers, your employees, and your communities with respect, and you will earn their loyalty. Our strategy has never been about selling a product but instead about finding ways to help make life more rewarding for our customers. This is no simple task as customer needs and service preferences are constantly changing. Our success begins and ends with creating positive experiences, one customer at a time.

Our employees remain the driving force in consistently earning the loyalty of our customers. They do what most would consider an impossible feat...they master the art of balancing the desire to satisfy the customer with the Company's need to be profitable. This balance is our strength.

As always, our Company and our employees remain committed to the prosperity of the communities we serve, supporting worthwhile causes that enhance the lives of the residents. We believe in being good citizens and good neighbors.

A Season of Looking Ahead.....

Our strategic goals for 2004 focused on preparing the Company for continued growth into 2005. In June, we completed an in-market acquisition of two offices of The Legacy Bank. Not only did this acquisition expand our presence in Towanda and Sayre, two areas we have identified as growth markets, but it also illustrates a commitment by our Board of Directors to remain an independent, community bank.

Our Investment Services division made significant strides throughout the year in integrating investment products and services into our daily delivery of financial product options. We believe that most employees and customers now see these products and services as viable solutions to meet their savings and investment goals. Bob Mosso was named Vice President, Manager of Investments and Trust in April of 2004. Bob's leadership, along with a strong commitment from our employees, pushed investment sales to their highest levels since we first introduced these services.

Regulatory requirements related to terrorist activities and organizational mismanagement as documented in well published cases, have placed increasing demands on banks to implement additional, and often costly, security measures. The Company's regulatory relationships and operating culture position us to meet the compliance requirements, while our earnings growth supports the increased regulatory costs.

Our continued focus on our customers and their success resulted in an outstanding year in terms of financial performance. Total assets increased \$35.5 million to just under \$500 million, an increase of 7.6% over last year. Total deposits grew 8.7% while total loans grew 13.2% to \$419.1 million and \$359.7 million, respectively. Stockholders' equity (excluding accumulated other comprehensive income) increased \$3.1 million, or 8.1% over the prior year.

Consolidated net income for the year was \$5.3 million compared to \$4.9 million in 2003, an increase of 8.0%. Earnings per share was \$1.85, which represents an 8.8% increase over 2003 earnings per share of \$1.70. It should be noted however that excluding our conservative decision to record an after-tax, non-cash impairment charge for our Freddie Mac preferred stock totaling \$479,000, net income for 2004 would have been \$5.7 million and earnings per share would have been \$2.02, an 18.8% increase over last year. Cash dividends paid of \$.78 per share represented an increase of 5.4% over 2003.

....Toward the Horizon of a Bright Future

In 2005, Citizens Financial Services, Inc. will face new challenges due to the changing economic environment. Our 2005 strategic objectives meet these economic challenges head on while allowing us to remain committed to our philosophy of respect for the customer, employee and community.

Our greatest challenge will be managing the impact on our margin that will occur from the rise in short-term rates and a flattening of the yield curve. As a result of the compression on margin, we must place a greater emphasis on non-interest income opportunities in order to achieve the aggressive growth goals set forth by our Board of Directors. This challenge provides us with an opportunity to focus our resources on key areas that contribute to non-interest income including investments, trust, loan growth, fee income and cost control.

Our focus on Investment services will continue to intensify. Our employees have embraced Investment services as a valuable option for helping their customers achieve financial security. The significant increase in community office referrals to our investment representatives in 2004 was a clear indication of the need for these services. In 2005, we will continue to promote the need for financial and retirement planning as a means to attaining financial security. The positive impact this has on our customers continues to motivate us.

The year 2005 will bring a renewed focus on building our Trust relationships. We are proud to welcome Trust Officer Linda Kriner to our family. The extensive knowledge and experience that Linda brings to our Investment and Trust Services Division team will help us advance our commitment to providing high-quality investment products and services to our customers. Improving employee knowledge about our Trust services will be a priority to provide our customers with yet another option for achieving financial security and peace of mind.

Loan growth will come as a result of leveraging an enhanced line of loan products and a skilled employee base with a feet-on-the-street approach to sales. In 2004, our managers, business development officers and I met with existing and future customers. Customers need to see us. They need to hear from us. In 2005, feet-on-the-street will become everyone's job to ensure the effective flow of information between the Bank and our customers.

Commitment to meeting the needs of our small business customers will continue to be strong. This is especially important in light of the changing face of the agricultural industry. We are proud to have several business development officers who have a strong farm background and who are highly skilled in the area of agricultural lending. We intend to leverage their knowledge and skills to assist our agricultural community to grow and prosper.

In 2005, we are committed to focusing on employee satisfaction like never before. We recently asked our employees to complete a survey to help us better understand their needs and their feelings about First Citizens. I'm proud to share with you that 84% of our employees would recommend First Citizens as an employer. Our goal is to ensure our employees have rewarding work environments and the skills and leadership they need to excel in their careers. We believe that great service comes from retaining great employees.

I could not end without expressing my appreciation to my partners, the executive management team. Without their dedication, leadership, knowledge, execution and willingness to support our vision and our plan, the magnitude of our successes would be diminished. I would also like to thank the Board of Directors, our employees and customers for their support in my first year as CEO and President.

I believe in the strength of our organization and its people. Our efforts in 2004 are unfolding into a bright future for 2005 and beyond.

Randall E. Black
CEO & President

To ensure our long-term survival as a highly successful independent community bank by consistently exceeding customer expectations, cultivating effective employees, delivering superior shareholder value and exhibiting social responsibility and good citizenship.

1. EXCEEDING CUSTOMER EXPECTATIONS

- *Make every customer feel significant* - Effectively execute on our core service standards.
- *Market to a Segment of One* - Segment customers and use a variety of methods to continuously identify their needs and priorities, their satisfaction with our ability to meet those needs and their loyalty to First Citizens.
- *Identify and reward loyal customers.*

2. CULTIVATE EFFECTIVE EMPLOYEES - *Great Service comes from Great Employees*

Provide employees with the knowledge, skills and motivation to perform consistently well.

- Ensure Integrity at the Top - People won't follow a person they don't trust.
- Create a fun-filled, passionate work environment.
- Consistently hire the best and the brightest.
- Train them well.
- Empower them with the authority to solve customer problems and reward customer loyalty.
- Respect Them.
- Reward Them - Understand what motivates employees, create an environment for them to motivate themselves, and reward desired positive behavior in a timely manner.

3. DELIVER SUPERIOR SHAREHOLDER VALUE

- Provide a return on equity that consistently exceeds our peers and meets shareholder expectations.
- Operate and manage the bank in a cost efficient manner which contributes to the overall financial performance without sacrificing customer service and satisfaction.
- Identify, assess and monitor all risks of the bank in such a manner that allows us to maximize returns within our accepted risk tolerance levels.

4. EXHIBIT SOCIAL RESPONSIBILITY AND GOOD CITIZENSHIP

- *Answer the Call* - Be proactive in contributing knowledge, skills, time and money to organizations within our community that impact its economic and social vitality.
- *Encourage Employee Participation* - Support and encourage employee involvement in schools, community groups, professional associations and charities.
- *Be a leader and role model for other organizations.*

(in thousands, except share data)	December 31,	
	2004	2003
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	\$ 9,162	\$ 9,624
Interest-bearing	177	327
Total cash and cash equivalents	9,339	9,951
Available-for-sale securities	95,747	106,587
Loans (net of allowance for loan losses		
2004, \$3,919; 2003, \$3,620)	355,774	314,037
Premises and equipment	11,833	10,645
Accrued interest receivable	1,736	1,703
Goodwill	8,605	6,905
Core deposit intangible	1,262	978
Bank owned life insurance	7,449	7,142
Other assets	7,602	5,930
TOTAL ASSETS	\$ 499,347	\$ 463,878
LIABILITIES:		
Deposits:		
Noninterest-bearing	\$ 46,866	\$ 46,820
Interest-bearing	372,208	338,871
Total deposits	419,074	385,691
Borrowed funds	34,975	35,296
Accrued interest payable	1,870	1,888
Other liabilities	2,639	2,474
TOTAL LIABILITIES	458,558	425,349
STOCKHOLDERS' EQUITY:		
Common Stock		
\$1.00 par value; authorized 10,000,000 shares;		
issued 2,937,519 and 2,909,849		
shares in 2004 and 2003, respectively	2,938	2,910
Additional paid-in capital	10,804	10,213
Retained earnings	28,894	26,455
TOTAL	42,636	39,578
Accumulated other comprehensive income	164	956
Less: Treasury stock, at cost		
97,262 and 96,962 shares for 2004 and 2003,		
respectively	(2,011)	(2,005)
TOTAL STOCKHOLDERS' EQUITY	40,789	38,529
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 499,347	\$ 463,878
<i>See accompanying notes to consolidated financial statements.</i>		

	Year Ended December 31,		
(in thousands, except per share data)	2004	2003	2002
INTEREST INCOME:			
Interest and fees on loans	\$ 22,600	\$ 21,593	\$ 21,600
Interest-bearing deposits with banks	10	29	65
Investment securities:			
Taxable	3,413	3,222	4,711
Nontaxable	301	457	634
Dividends	282	314	367
TOTAL INTEREST INCOME	26,606	25,615	27,377
INTEREST EXPENSE:			
Deposits	8,283	8,501	10,012
Borrowed funds	952	325	392
TOTAL INTEREST EXPENSE	9,235	8,826	10,404
NET INTEREST INCOME	17,371	16,789	16,973
Provision for loan losses	-	435	435
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	17,371	16,354	16,538
NON-INTEREST INCOME:			
Service charges	3,017	3,018	3,130
Trust	434	422	467
Brokerage	185	200	95
Gains on loans sold	54	349	185
Investment securities (losses) gains, net	(235)	553	254
Earnings on bank owned life insurance	307	142	-
Other	530	628	915
TOTAL NON-INTEREST INCOME	4,292	5,312	5,046
NON-INTEREST EXPENSES:			
Salaries and employee benefits	7,636	8,304	7,120
Occupancy	1,072	1,025	998
Furniture and equipment	695	713	881
Professional fees	630	694	667
Amortization of intangibles	506	435	457
Other	4,383	4,330	4,103
TOTAL NON-INTEREST EXPENSES	14,922	15,501	14,226
Income before provision for income taxes	6,741	6,165	7,358
Provision for income taxes	1,474	1,286	1,763
NET INCOME	\$ 5,267	\$ 4,879	\$ 5,595
NET INCOME - EARNINGS PER SHARE	\$ 1.85	\$ 1.70	\$ 1.94

**CASH DIVIDENDS PER
SHARE**

\$	0.78	\$	0.74	\$	0.67
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See accompanying notes to consolidated financial statements.

(in thousands, except share data)	Common Stock		Additional	Retained	Accumulated	Treasury	Total
	Shares	Amount	Paid-in Capital	Earnings	Comprehensive Income(Loss)		
Balance, December 31, 2001	2,854,582	\$ 2,855	\$ 9,017	\$ 21,253	\$ 1,213	\$ (949)	\$ 33,389
Comprehensive income:							
Net income				5,595			5,595
Change in net unrealized gain on securities available-for-sale, net of taxes of \$690					1,340		1,340
Total comprehensive income							6,935
Stock dividend	27,488	27	456	(483)			
Cash dividends, \$.67 per share				(1,918)			(1,918)
Balance, December 31, 2002	2,882,070	2,882	9,473	24,447	2,553	(949)	38,406
Comprehensive income:							
Net income				4,879			4,879
Change in net unrealized loss on securities available-for-sale, net of tax benefit of \$823					(1,597)		(1,597)
Total comprehensive income							3,282
Stock dividend	27,779	28	740	(768)			
Purchase of treasury stock (41,800 shares)						(1,056)	(1,056)
Cash dividends, \$.74 per share				(2,103)			(2,103)
Balance, December 31, 2003	2,909,849	2,910	10,213	26,455	956	(2,005)	38,529
Comprehensive income:							
Net income				5,267			5,267
Change in net unrealized loss on securities available-for-sale, net of tax benefit of \$408					(792)		(792)
Total comprehensive income							4,475
Stock dividend	27,670	28	591	(619)			
Purchase of treasury stock (300 shares)						(6)	(6)
Cash dividends, \$.78 per share				(2,209)			(2,209)
Balance, December 31, 2004	2,937,519	\$ 2,938	\$ 10,804	\$ 28,894	\$ 164	\$ (2,011)	\$ 40,789

	2004	2003	2002
Components of comprehensive income (loss):			
Change in net unrealized gain (loss) on investment securities available-for-sale	\$ (947)	\$ (1,232)	\$ 1,508

Investment losses (gains) included in net
income, net

of taxes (benefits) of \$(80), \$188 and \$86	155	(365)	(168)
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Total	\$	(792)	\$	(1,597)	\$	1,340
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See accompanying notes to consolidated financial statements.

(in thousands)	Year Ended December 31,		
	2004	2003	2002
Cash Flows from Operating Activities:			
Net income	\$ 5,267	\$ 4,879	\$ 5,595
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	-	435	435
Depreciation and amortization	1,444	1,358	1,447
Amortization and accretion on investment securities	912	1,129	690
Deferred income taxes	(166)	(141)	116
Investment securities losses (gains), net	235	(553)	(254)
Earnings on bank owned life insurance	(307)	(142)	-
Realized gains on loans sold	(54)	(349)	(185)
Originations of loans held for sale	(3,048)	(22,435)	(11,857)
Proceeds from sales of loans held for sale	3,102	23,749	13,119
Decrease (increase) in accrued interest receivable	(33)	273	10
Decrease in accrued interest payable	(18)	(189)	(208)
Other, net	(167)	1,626	(1,128)
Net cash provided by operating activities	7,167	9,640	7,780
Cash Flows from Investing Activities:			
Available-for-sale securities:			
Proceeds from sales of available-for-sale securities	14,045	12,108	13,927
Proceeds from maturity and principal repayments of securities	24,571	49,343	34,090
Purchase of securities	(30,122)	(71,320)	(32,899)
Proceeds from redemption of Regulatory Stock	1,585	746	1,082
Purchase of Regulatory Stock	(1,814)	(1,757)	(421)
Net increase in loans	(15,405)	(20,819)	(28,045)
Purchase of loans	(27,340)	-	-
Purchase of bank owned life insurance	-	(7,000)	-
Purchase of premises and equipment	(2,319)	(490)	(473)
Proceeds from sale of premises and equipment	34	-	275
Deposit acquisition premium	(2,200)	-	-
Proceeds from sale of foreclosed assets held for sale	338	155	422
Net cash used in investing activities	(38,627)	(39,034)	(12,042)
Cash Flows from Financing Activities:			
Net increase in deposits	12,720	12,641	2,577
Proceeds from long-term borrowings	654	18,202	1,268
Repayments of long-term borrowings	(1,519)	(2,569)	(949)
Net increase in short-term borrowed funds	545	2,636	3,398
Dividends paid	(2,209)	(2,103)	(1,918)
Deposits of acquired branches	20,663	-	-
Purchase of treasury stock	(6)	(1,056)	-
Net cash provided by financing activities	30,848	27,751	4,376
Net (decrease) increase in cash and cash equivalents	(612)	(1,643)	114
Cash and Cash Equivalents at Beginning of Year	9,951	11,594	11,480
Cash and Cash Equivalents at End of Year	\$ 9,339	\$ 9,951	\$ 11,594

Supplemental Disclosures of Cash Flow**Information:**

Interest paid	\$	9,253	\$	9,015	\$	10,612
Income taxes paid	\$	1,780	\$	1,265	\$	1,755
Noncash activities:						
Real estate acquired in settlement of loans	\$	718	\$	218	\$	162

See accompanying notes to consolidated financial statements.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BUSINESS AND ORGANIZATION

Citizens Financial Services, Inc. (individually and collectively, the “Company”), is headquartered in Mansfield, Pennsylvania, and provides a full range of banking and related services through its wholly owned subsidiary, First Citizens National Bank (the “Bank”), and its wholly owned subsidiary, First Citizens Insurance Agency, Inc. The Bank is a national banking association and operates fifteen full-service banking offices in Potter, Tioga and Bradford counties. The Bank also provides trust services, including the administration of trusts and estates, retirement plans, and other employee benefit plans, along with a comprehensive menu of investment services. The Bank serves individual and corporate customers and is subject to competition from other financial institutions and intermediaries with respect to these services. The Company is supervised by the Board of Governors of the Federal Reserve System, while the Bank is subject to regulation and supervision by the Office of the Comptroller of the Currency.

A summary of significant accounting and reporting policies applied in the presentation of the accompanying financial statements follows:

BASIS OF PRESENTATION

The financial statements are consolidated to include the accounts of the Company and its subsidiary, First Citizens National Bank, and its subsidiary, First Citizens Insurance Agency, Inc. These statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

In preparing the financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities as of the balance sheet date and revenues and expenses for the period. Actual results could differ significantly from those estimates.

OPERATING SEGMENTS

Statement of Financial Accounting Standards (FAS) No. 131 requires disclosures about an enterprise’s operating segments in financial reports issued to shareholders. The Statement defines an operating segment as a component of an enterprise that engages in business activities that generates revenue and incurs expense, and the operating results of which are reviewed by the chief operating decision maker in the determination of resource allocation and performance. While the Company’s chief decision makers monitor the revenue streams of the various Company’s products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Consistent with our internal reporting, the Company’s business activities are reported as one segment, which is community banking.

INVESTMENT SECURITIES

Investment securities at the time of purchase are classified as one of the three following types:

Held-to-Maturity Securities - includes securities that the Company has the positive intent and ability to hold to maturity. These securities are reported at amortized cost. The Company had no held-to-maturity securities as of December 31, 2004 and 2003.

Trading Securities - includes debt and equity securities bought and held principally for the purpose of selling them in the near term. Such securities are reported at fair value with unrealized holding gains and losses included in earnings. The Company had no trading securities as of December 31, 2004 and 2003.

Available-for-Sale Securities - includes debt and equity securities not classified as held-to-maturity or trading securities. Such securities are reported at fair value, with unrealized holding gains and losses excluded from earnings and reported as a separate component of stockholders’ equity, net of estimated income tax effect.

The amortized cost of investment in debt securities is adjusted for amortization of premiums and accretion of discounts, computed by a method that results in a level yield. Gains and losses on the sale of investment securities are computed on the basis of specific identification of the adjusted cost of each security.

On a monthly basis the Company evaluates the severity and duration of impairment for its investment securities portfolio to determine if the impairment is other than temporary. Several factors are evaluated and analyzed, including the Company's positive intent and ability to hold the security for a period of time sufficient to allow a market recovery without incurring a loss.

Common stock of the Federal Reserve Bank and Federal Home Loan Bank represents ownership in institutions which are wholly owned by other financial institutions. These equity securities are accounted for at cost and are classified as other assets.

The fair value of investments, except certain state and municipal securities, is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers. The fair value of certain state and municipal securities is not readily available through market sources other than dealer quotations, so fair value estimates are based on quoted market prices of similar instruments, adjusted for differences between the quoted instruments and the instruments being valued.

LOANS

Interest on all loans is recognized on the accrual basis based upon the principal amount outstanding. The accrual of interest income on loans is discontinued when, in the opinion of management, there exists doubt as to the ability to collect such interest. Payments received on nonaccrual loans are applied to the outstanding principal balance or recorded as interest income, depending upon our assessment of our ultimate ability to collect principal and interest. Loans are returned to the accrual status when factors indicating doubtful collectibility cease to exist.

The Company recognizes nonrefundable loan origination fees and certain direct loan origination costs over the life of the related loan as an adjustment of loan yield using the interest method.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses which is charged to operations. The provision is based upon management's periodic evaluation of individual loans, the overall risk characteristics of the various portfolio segments, past experience with losses, the impact of economic conditions on borrowers, and other relevant factors. The estimates used in determining the adequacy of the allowance for loan losses are particularly susceptible to significant change in the near term.

Impaired loans are commercial and commercial real estate loans for which it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Company individually evaluates such loans for impairment and does not aggregate loans by major risk classifications. The definition of "impaired loans" is not the same as the definition of "nonaccrual loans," although the two categories overlap. The Company may choose to place a loan on nonaccrual status due to payment delinquency or uncertain collectibility, while not classifying the loan as impaired if the loan is not a commercial or commercial real estate loan. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of impaired loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value; or, as a practical expedient in the case of a loan in the process of collection, the difference between the fair value of the collateral and the recorded amount of the loans.

Mortgage loans on one- to four-family properties and all consumer loans are large groups of smaller balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which is defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed.

FORECLOSED ASSETS HELD FOR SALE

Foreclosed assets acquired in settlement of foreclosed loans are carried at the lower of cost or fair value minus estimated costs to sell. Prior to foreclosure, the value of the underlying loan is written down to fair market value of the real estate or other assets to be acquired by a charge to the allowance for loan losses, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of related income and losses on disposition, are included in other expenses and gains are included in other income.

PREMISES AND EQUIPMENT

Premises and equipment are stated at cost, less accumulated depreciation. Depreciation expense is computed on straight line and accelerated methods over the estimated useful lives of the assets, which range from 3 to 15 years for furniture, fixtures and equipment and 5 to 39 1/2 years for building premises. Repair and maintenance expenditures which extend the useful life of an asset are capitalized and other repair expenditures are expensed as incurred.

When premises or equipment are retired or sold, the remaining cost and accumulated depreciation are removed from the accounts and any gain or loss is credited or charged to income.

INTANGIBLE ASSETS

Intangible assets include core deposit intangibles, which are a measure of the value of consumer demand and savings deposits acquired in business combinations accounted for as purchases. The core deposit intangibles are being amortized to expense over a 5 1/2 year life on a straight-line basis. The recoverability of the carrying value of intangible assets is evaluated on an ongoing basis, and permanent declines in value, if any, are charged to expense.

GOODWILL

The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards ("FAS") No. 142, "Goodwill and Other Intangible Assets". This statement, among other things, requires a two-step process for testing the impairment of goodwill on at least an annual basis. This approach could cause more volatility in the Company's reported net income because impairment losses, if any, could occur irregularly and in varying amounts. The Company performs an annual impairment analysis of goodwill. Based on the fair value of the reporting unit, estimated using the expected present value of future cash flows, no impairment of goodwill was recognized in 2004 and 2003.

BANK OWNED LIFE INSURANCE

The Company has purchased life insurance policies on certain officers, and is the sole beneficiary on those policies. Bank owned life insurance is recorded at its cash surrender value, or the amount that can be realized. Increases in the cash surrender value are recognized as other non-interest income.

INCOME TAXES

The Company and the Bank file a consolidated federal income tax return. Deferred tax assets and liabilities are computed based on the difference between the financial statement basis, and income tax basis of assets and liabilities using the enacted marginal tax rates. Deferred income tax expenses or benefits are based on the changes in the net deferred tax asset or liability from period to period.

EMPLOYEE BENEFIT PLANS

The Company has a noncontributory defined benefit pension plan covering substantially all employees. It is the Company's policy to fund pension costs on a current basis to the extent deductible under existing tax regulations. Such contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

The Company also has a profit-sharing plan which provides tax-deferred salary savings to plan participants.

MORTGAGE SERVICING RIGHTS (MSR'S)

The Company originates certain loans for the express purpose of selling such loans in the secondary market. The Company maintains all servicing rights for these loans. The loans held for sale are carried at lower of cost or market. Originated MSR's are recorded by allocating total costs incurred between the loan and servicing rights based on their relative fair values. MSR's are amortized in proportion to the estimated servicing income over the estimated life of the servicing portfolio.

COMPREHENSIVE INCOME

The Company is required to present comprehensive income in a full set of general purpose financial statements for all periods presented. Other comprehensive income is comprised exclusively of unrealized holding gains (losses) on the available-for-sale securities portfolio. The Company has elected to report the effects of other comprehensive income as part of the Consolidated Statement of Changes in Stockholders' Equity.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 123 (Revised 2004), "Share-Based Payment". The Statement requires that compensation cost relating to share-based payment transactions be recognized in financial statements and that this cost be measured based on the fair value of the equity or liability instruments issued. FAS No. 123 (Revised 2004) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The adoption of this statement is not expected to have a material impact on the consolidated financial statements.

In October 2003, the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 03-3, "Accounting for Loans or Certain Debt Securities Acquired in a Transfer." SOP 03-3 applies to a loan that is acquired where it is probable, at acquisition, that a transferee will be unable to collect all contractually required payments receivable. SOP 03-3 requires the recognition, as accretable yield, the excess of all cash flows expected at acquisition over the investor's initial investment in the loan as interest income on a level-yield basis over the life of the loan. The amount by which the loan's contractually required payments exceed the amount of its expected cash flows at acquisition may not be recognized as an adjustment to yield, a loss accrual or a valuation allowance for credit risk. SOP 03-3 is effective for loans acquired in fiscal years beginning after December 31, 2004. Early adoption is permitted. The adoption of SOP 03-3 is not expected to have a material impact on the consolidated financial statements.

TREASURY STOCK

The purchase of the Company's common stock is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of such stock on a last-in-first-out basis.

CASH FLOWS

The Company utilizes the net reporting of cash receipts and cash payments for deposit and lending activities. The Company considers amounts due from banks and interest-bearing deposits in banks as cash equivalents.

TRUST ASSETS AND INCOME

Assets held by the Bank 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 Bank.

EARNINGS PER SHARE

Earnings per share calculations give retroactive effect to stock dividends declared by the Company. The number of weighted average shares used in the earnings per share computations presented was 2,840,393, 2,869,303, and 2,882,358 for 2004, 2003 and 2002, respectively. The Company has no dilutive securities.

RECLASSIFICATION

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.

2. RESTRICTIONS ON CASH AND DUE FROM BANKS

The Bank is required to maintain reserves, in the form of cash and balances with the Federal Reserve Bank, against its deposit liabilities. The amount of such reserves was \$833,000 and \$554,000 at December 31, 2004 and 2003, respectively.

Deposits with one financial institution are insured up to \$100,000. The Company maintains cash and cash equivalents with other financial institutions in excess of the insured amount.

3. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities at December 31, 2004 and 2003, were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2004				
Available-for-sale securities:				
U.S. Agency securities	\$ 5,829	\$ -	\$ (17)	\$ 5,812
Obligations of state and political subdivisions	7,203	249	-	7,452
Corporate obligations	8,523	412	-	8,935
Mortgage-backed securities	70,845	204	(600)	70,449
Equity securities	3,099	-	-	3,099
Total available-for-sale	\$ 95,499	\$ 865	\$ (617)	\$ 95,747

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2003				
Available-for-sale securities:				
U.S. Agency securities	\$ 1,005	\$ 28	\$ -	\$ 1,033
Obligations of state and political subdivisions	8,011	292	-	8,303
Corporate obligations	13,656	1,018	-	14,674
Mortgage-backed securities	78,080	671	(375)	78,376
Equity securities	4,387	35	(221)	4,201
Total available-for-sale	\$ 105,139	\$ 2,044	\$ (596)	\$ 106,587

The following table shows the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at December 31, 2004 (in thousands):

	Less than Twelve Months		Twelve Months or Greater		Total	
	Approx Market Value	Gross Unrealized Losses	Approx Market Value	Gross Unrealized Losses	Approx Market Value	Gross Unrealized Losses
U.S. Government agencies and corporations	\$ 4,131	\$ 17	\$ -	\$ -	\$ 4,131	\$ 17
Mortgage-backed securities	47,525	472	12,006	128	59,531	600
Total	\$ 51,656	\$ 489	\$ 12,006	\$ 128	\$ 63,662	\$ 617

The Company's investment securities portfolio contains unrealized losses of mortgage-related instruments or other agency securities issued or backed by the full faith and credit of the United States government or are generally viewed as having the implied guarantee of the U.S. government.

The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not permanent, but rather, temporary, and 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 during 2004, 2003, and 2002 were \$14,045,000, \$12,108,000 and \$13,927,000, respectively. Gross gains and gross losses were realized on those sales as follows (in thousands):

	2004	2003	2002
Gross gains	\$ 517	\$ 553	\$ 287
Gross losses	26	-	33
Net gains (losses)	\$ 491	\$ 553	\$ 254

Additionally in 2004, the Company recorded an other-than-temporary impairment non-cash charge of \$726,000 related to \$3,825,000 face value of perpetual preferred stock issued by Freddie Mac, a government sponsored entity. Prior to this impairment charge, the decline in value of these securities was recorded as an unrealized marked-to-market loss on securities available for sale and reflected as a reduction in stockholders' equity through other comprehensive income.

Investment securities with an approximate carrying value of \$71,899,000 and \$64,788,000 at December 31, 2004 and 2003, 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 carrying value of debt securities at December 31, 2004, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Estimated Fair Value
Available-for-sale securities:		
Due in one year or less	\$ -	\$ -
Due after one year through five years	16,522	16,943
Due after five years through ten years	59,814	59,529
Due after ten years	16,064	16,176
Total	\$ 92,400	\$ 92,648

4. LOANS

The Company grants commercial, industrial, residential, and consumer loans primarily to customers throughout Northcentral Pennsylvania and Southern New York. Although the Company has a diversified loan portfolio at December 31, 2004 and 2003, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

Major classifications of loans are as follows (in thousands):

	December 31,	
	2004	2003
Real estate loans:		
Residential	\$ 189,803	\$ 180,333
Commercial	75,228	57,370
Agricultural	11,564	7,594
Construction	7,282	5,784
Loans to individuals for household, family and other purchases	12,657	13,145
Commercial and other loans	28,069	16,219
State and political subdivision loans	35,090	37,212
	359,693	317,657
Less allowance for loan losses	3,919	3,620
Loans, net	\$ 355,774	\$ 314,037

Real estate loans serviced for Freddie Mac, which are not included in the consolidated balance sheet, totaled \$34,514,000 and \$35,643,000 at December 31, 2004 and 2003, respectively.

At December 31, 2004 and 2003, net unamortized loan fees and costs of \$829,000 and \$784,000, respectively, have been deducted from the carrying value of loans.

The Company had nonaccrual loans, inclusive of impaired loans, of \$1,783,000 and \$2,504,000 at December 31, 2004 and 2003, respectively. Interest income on loans would have increased by approximately \$44,000, \$49,000 and \$84,000 during 2004, 2003 and 2002, respectively, if these loans had performed in accordance with their original terms.

Information with respect to impaired loans as of and for the year ended December 31, is as follows (in thousands):

	2004	2003	2002
Impaired loans without related allowance for loan losses	\$ 229	\$ 1,197	\$ -
Impaired loans with related allowance for loan losses	832	729	1,916
Related allowance for loan losses	6	35	327
Average recorded balance of impaired loans	1,091	1,772	1,967
Interest income recognized on impaired loans	18	35	-

Transactions in the allowance for loan losses were as follows (in thousands):

	Year Ended December 31,		
	2004	2003	2002
Balance, beginning of year	\$ 3,620	\$ 3,621	\$ 3,250
Provision charged to income	-	435	435
Increase related to acquisition	290	-	-
Recoveries on loans previously charged against the allowance	324	116	115
	4,234	4,172	3,800
Loans charged against the allowance	(315)	(552)	(179)
Balance, end of year	\$ 3,919	\$ 3,620	\$ 3,621

The following is a summary of the past due and nonaccrual loans as of December 31, 2004 and 2003 (in thousands):

	December 31, 2004		
	Past Due 30 - 89 days	Past Due 90 days or more	Nonaccrual
Real estate loans	\$ 1,811	\$ 346	\$ 1,542
Installment loans	153	23	36
Credit cards and related loans	20	3	-
Commercial and all other loans	199	65	205
Total	\$ 2,183	\$ 437	\$ 1,783

	December 31, 2003		
	Past Due 30 - 89 days	Past Due 90 days or more	Nonaccrual
Real estate loans	\$ 1,420	\$ 170	\$ 2,491
Installment loans	167	12	13
Credit cards and related loans	27	-	-
Commercial and all other loans	38	3	-
Total	\$ 1,652	\$ 185	\$ 2,504

5. PREMISES & EQUIPMENT

Premises and equipment are summarized as follows (in thousands):

	December 31,	
	2004	2003
Land	\$ 2,767	\$ 1,867
Buildings	10,484	9,723
Furniture, fixtures and equipment	6,765	6,598
Construction in process	56	32
	20,072	18,220
Less accumulated depreciation	8,239	7,575
Premises and equipment, net	\$ 11,833	\$ 10,645

Depreciation expense amounted to \$833,000, \$836,000 and \$990,000 for 2004, 2003, and 2002, respectively.

6. DEPOSITS

Certificates of deposit of \$100,000 or more amounted to \$51,719,000 and \$41,362,000 at December 31, 2004 and 2003, respectively. Interest expense on certificates of deposit of \$100,000 or more amounted to \$1,843,000, \$1,618,000 and \$1,654,000 for the years ended December 31, 2004, 2003, and 2002, respectively.

Following are maturities of certificates of deposit as of December 31, 2004 (in thousands):

2005	\$ 95,738
2006	44,458
2007	41,147
2008	18,581
2009	12,997
Thereafter	2,856
Total certificates of deposit	\$ 215,777

7. BORROWED FUNDS

	Securities Sold Under Agreements to	TT&L	FHLB	Notes	Term	Total
(dollars in thousands)	Repurchase(a)	Borrowings(b)	Advances(c)	Payable(d)	Loans(e)	Borrowed Funds
2004						
Balance at December 31	\$ 10,390	\$ -	\$ 7,085	\$ 7,500	\$ 10,000	\$ 34,975
Highest balance at any month-end	12,927	3,217	8,062	7,500	15,821	47,527
Average balance	8,325	413	3,623	7,500	15,256	35,117
Weighted average interest rate:						
Paid during the year	2.69%	2.96%	1.73%	4.36%	2.14%	2.27%
As of year-end	2.93%	0.00%	2.21%	5.30%	2.35%	2.53%
2003						
Balance at December 31	\$ 8,495	\$ 2,203	\$ 1,160	\$ 7,500	\$ 15,938	\$ 35,296
Highest balance at any month-end	14,460	4,602	8,670	7,500	15,938	51,170
Average balance	10,019	461	2,322	308	1,167	14,277
Weighted average interest rate:						
Paid during the year	2.44%	2.08%	1.29%	4.03%	2.46%	2.24%
As of year-end	2.50%	0.69%	1.03%	3.97%	2.05%	2.05%
2002						
Balance at December 31	\$ 7,647	\$ -	\$ 7,380	\$ -	\$ 2,000	\$ 17,027
Highest balance at any month-end	14,897	-	7,380	-	2,000	24,277
Average balance	11,096	-	1,208	-	2,000	14,304
Weighted average interest rate:						
Paid during the year	2.69%	0.00%	1.59%	0.00%	3.64%	2.73%
As of year-end	2.94%	0.00%	1.31%	0.00%	3.13%	2.25%

(a) Securities sold under agreements to repurchase mature within 5 1/2 years. The carrying value of the underlying securities at December 31, 2004 and 2003 was \$15,146,000 and \$14,923,000, respectively.

(b) TT&L borrowings consist of notes issued under the U.S. Treasury Department's program of investing the treasury tax and loan account balances in interest-bearing demand notes insured by depository institutions. These notes bear interest at a rate of .25 percent less than the average Federal funds rate as computed by the Federal Reserve Bank.

(c) FHLB Advances consist of an "Open RepoPlus" agreement with the Federal Home Loan Bank of Pittsburgh. FHLB "Open RepoPlus" advances are short-term borrowings that bear interest based on the Federal Home Loan Bank discount rate or Federal Funds rate, whichever is higher. The Company has a borrowing limit of \$202,667,000, inclusive of any outstanding advances. Although no specific collateral is required to be pledged for the "Open RepoPlus" borrowings, FHLB advances are secured by a blanket security agreement that includes the Company's FHLB stock, as well as investment and mortgage-backed securities held in safekeeping at the FHLB and certain residential mortgage loans. At December 31, 2004 and 2003, the approximate carrying value of the securities collateral was \$66,651,000 and \$69,162,000, respectively.

(d) In December 2003, the Company formed a special purpose entity ("Entity") to issue \$7,500,000 of floating rate obligated mandatory redeemable securities as part of a pooled offering. The rate is determined quarterly and floats

based on the 3 month LIBOR plus 2.80%. At December 31, 2004 and 2003, the rate was 5.30% and 3.97%, respectively. The Entity may redeem them, in whole or in part, at face value after December 17, 2008. The Company borrowed the proceeds of the issuance from the Entity in December 2003 in the form of a \$7,500,000 note payable. Debt issue costs of \$75,000 have been capitalized and are being amortized through the first call date. 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.

(e) Term Loans consist of separate loans with a third party bank and the Federal Home Loan Bank of Pittsburgh as follows (in thousands):

Interest Rate	Maturity	December 31, 2004	December 31, 2003
Variable:			
(f)	August 31, 2005	\$ -	\$ 938
Fixed:			
2.34%	December 29, 2004	-	5,000
1.81%	June 17, 2005	3,000	3,000
2.45%	June 19, 2006	4,000	4,000
2.76%	December 18, 2006	3,000	3,000
Total term loans		\$ 10,000	\$ 15,938

(f) Interest rate floats monthly based on the 1 month LIBOR +1.75%, the interest rate was 4.07% and 2.92% at December 31, 2004 and 2003, respectively. This line of credit has a borrowing limit of \$3.0 million and is renewable on an annual basis.

Following are maturities of borrowed funds as of December 31, 2004 (in thousands):

2005	\$ 17,949
2006	8,689
2007	727
2008	7,500
2009	-
Thereafter	110
Total borrowed funds	\$ 34,975

8. EMPLOYEE BENEFIT PLANS

The Bank sponsors a trustee, noncontributory defined benefit pension plan covering substantially all employees and officers. The plan calls for benefits to be paid to eligible employees at retirement based primarily upon years of service with the Bank and compensation rates near retirement. The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plan's actuary.

Obligations and Funded Status
At December 31 (in thousands):

	Pension Benefits	
	2004	2003
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 4,785	\$ 3,926
Service cost	336	340
Interest cost	295	267
Amendments	(3)	222
Assumption change	498	117
Benefits paid	(127)	(87)
Benefit obligation at end of year	5,784	4,785
Change in plan assets		
Fair value of plan assets at beginning of year	4,014	3,117
Actual return on plan assets	253	530
Employer contribution	459	454
Benefits paid	(127)	(87)
Fair value of plan assets at end of year	4,599	4,014
Funded status	(1,185)	(771)
Transition adjustment	(10)	(25)
Unrecognized prior service cost	25	23
Unrecognized net gain from past experience different from that assumed	1,540	1,007
Prepaid benefit cost	\$ 370	\$ 234

The accumulated benefit obligation for all defined benefit pension plans was \$4,466,000 and \$3,638,000 at December 31, 2004 and 2003, respectively.

Components of Net Periodic Benefit Cost (in thousands):

	Pension Benefits	
	2004	2003
Service cost	\$ 336	\$ 340
Interest cost	295	267
Return on plan assets	(332)	(530)
Net amortization and deferral	24	325
Net periodic benefit cost	\$ 323	\$ 402

Assumptions

Weighted-average assumptions used to determine benefit obligations at December 31:

	Pension Benefits	
	2004	2003
Discount rate	5.75%	6.25%
Rate of compensation increase	3.25	3.25

Weighted-average assumptions used to determine net periodic benefit cost for the year ended December 31:

	Pension Benefits	
	2004	2003
Discount rate	5.75%	6.25%
Expected long-term return on plan assets	8.00	8.00
Rate of compensation increase	3.25	3.25

The long-term rate of return on plan assets gives consideration to returns currently being earned on plan assets as well as future rates expected to be earned.

Plan Assets

The Bank's pension plan weighted-average asset allocations at December 31, 2004 and 2003, by asset category are as follows:

	Plan Assets at December 31	
	2004	2003
Equity securities	67.4%	67.4%
Debt securities	25.0	30.3
Other	7.6	2.3
Total	100.0%	100.0%

Equity securities include the Bank's common stock in the amounts of \$257,000 (5.6% of total plan assets) and \$253,000 (6.3% of total plan assets) at December 31, 2004 and 2003, respectively.

The Bank expects to contribute \$412,000 to its pension plan in 2005. Expected future benefit payments that the Bank estimates from its pension plan are as follows:

2005	\$ 115,299
2006	135,675
2007	149,299
2008	174,451
2009	176,270
Thereafter	1,203,940

9. INCOME TAXES

The provision for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	2004	2003	2002
Currently payable	\$ 1,640	\$ 1,427	\$ 1,647
Deferred liability (benefit)	(166)	(141)	116
Provision for income taxes	\$ 1,474	\$ 1,286	\$ 1,763

The following temporary differences gave rise to the net deferred tax assets at December 31, 2004 and 2003 (in thousands):

	2004	2003
Deferred tax assets:		
Allowance for loan losses	\$ 1,146	\$ 1,038
Deferred compensation	556	546
Goodwill and core deposit intangibles	-	19
Merger & acquisition costs	49	24
Allowance for losses on available-for-sale securities	247	-
Foreclosed assets held for sale	7	3
Total	2,005	1,630
Deferred tax liabilities:		
Unrealized gains on available-for-sale securities	(84)	(492)
Depreciation and amortization	(315)	(301)
Bond accretion	(29)	(81)
Pension expense	(126)	(80)
Loan fees and costs	(94)	(77)
Goodwill and core deposit intangibles	(170)	-
Investment tax credits	(28)	-
Mortgage servicing rights	(75)	(88)
Total	(921)	(1,119)
Deferred tax asset, net	\$ 1,084	\$ 511

No valuation allowance was established at December 31, 2004 and 2003 in view of certain tax strategies coupled with the anticipated future taxable income as evidenced by the Company's earnings potential.

The total provision for income taxes is different from that computed at the statutory rates due to the following items (in thousands):

	Year Ended December 31,		
	2004	2003	2002
Provision at statutory rates on pre-tax income	\$ 2,287	\$ 2,096	\$ 2,502
Effect of tax-exempt income	(648)	(710)	(693)
Tax credits	(130)	(130)	(130)
Bank owned life insurance	(105)	(48)	-
Nondeductible interest	54	62	67
Other items	16	16	17
Provision for income taxes	\$ 1,474	\$ 1,286	\$ 1,763
Statutory tax rates	34%	34%	34%
Effective tax rates	21.9%	20.9%	24.0%

10. RELATED PARTY TRANSACTIONS

Certain executive officers, corporate directors or companies in which they have 10 percent or more beneficial ownership were indebted to the Bank.

A summary of loan activity with officers, directors, stockholders and associates of such persons is listed below (in thousands):

	Year Ended December 31,		
	2004	2003	2002
Balance, beginning of year	\$ 3,345	\$ 3,678	\$ 3,972
New loans	808	1,243	847
Repayments	(1,063)	(1,576)	(1,141)
Balance, end of year	\$ 3,090	\$ 3,345	\$ 3,678

Such loans were made in the ordinary course of business at the Bank's normal credit terms and do not present more than a normal risk of collection.

11. REGULATORY MATTERS

DIVIDEND RESTRICTIONS:

The approval of the Comptroller of the Currency is required for a national bank to pay dividends up to the Company if the total of all dividends declared in any calendar year exceeds the Bank's net income (as defined) for that year combined with its retained net income for the preceding two calendar years. Under this formula, the Bank can declare dividends in 2005 without approval of the Comptroller of the Currency of approximately \$2,638,000, plus the Bank's net income for 2005.

LOANS:

The Bank is subject to regulatory restrictions which limit its ability to loan funds to the Company. At December 31, 2004, the regulatory lending limit amounted to approximately \$4,424,000.

REGULATORY CAPITAL REQUIREMENTS:

Federal regulations require the Company and the Bank to maintain minimum amounts of capital. Specifically, each is required to maintain certain minimum dollar amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average total assets.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) established five capital categories ranging from “well capitalized” to “critically undercapitalized.” Should any institution fail to meet the requirements to be considered “adequately capitalized”, it would become subject to a series of increasingly restrictive regulatory actions.

As of December 31, 2004 and 2003, the Federal Reserve Board and the Office of the Comptroller of the Currency categorized the Company and the Bank as well capitalized, under the regulatory framework for prompt corrective action. To be categorized as a well capitalized financial institution, Total risk-based, Tier I risk-based and Tier I leverage capital ratios must be at least 10%, 6% and 5%, respectively.

The following table reflects the Company’s capital ratios at December 31 (in thousands):

	2004		2003	
	Amount	Ratio	Amount	Ratio
Total capital (to risk weighted assets)				
Company	\$ 42,156	12.86%	\$ 40,655	14.07%
For capital adequacy purposes	26,215	8.00%	23,115	8.00%
To be well capitalized	32,768	10.00%	28,894	10.00%
Tier I capital (to risk weighted assets)				
Company	\$ 38,236	11.67%	\$ 37,042	12.82%
For capital adequacy purposes	13,107	4.00%	11,557	4.00%
To be well capitalized	19,661	6.00%	17,336	6.00%
Tier I capital (to average assets)				
Company	\$ 38,236	7.84%	\$ 37,042	8.50%
For capital adequacy purposes	19,504	4.00%	17,437	4.00%
To be well capitalized	24,379	5.00%	21,796	5.00%

The following table reflects the Bank’s capital ratios at December 31 (in thousands):

	2004		2003	
	Amount	Ratio	Amount	Ratio
Total capital (to risk weighted assets)				
Bank	\$ 34,184	10.44%	\$ 33,862	11.73%
For capital adequacy purposes	26,190	8.00%	23,090	8.00%
To be well capitalized	32,738	10.00%	28,863	10.00%
Tier I capital (to risk weighted assets)				

Bank	\$	30,265	9.24%	\$	30,254	10.48%
For capital adequacy purposes		13,095	4.00%		11,545	4.00%
To be well capitalized		19,643	6.00%		17,318	6.00%

Tier I capital (to average assets)

Bank	\$	30,265	6.21%	\$	30,254	6.94%
For capital adequacy purposes		19,491	4.00%		17,433	4.00%
To be well capitalized		24,364	5.00%		21,792	5.00%

This annual report has not been reviewed, or confirmed for accuracy or relevance, by the Federal Deposit Insurance Corporation.

12. OFF-BALANCE-SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate or liquidity risk in excess of the amount recognized in the consolidated balance sheet.

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments whose contract amounts represent credit risk at December 31, 2004 and 2003, are as follows (in thousands):

	2004	2003
Commitments to extend credit	\$ 55,285	\$ 41,094
Standby letters of credit	\$ 1,528	\$ 1,404

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Company on extension of credit is based on management's credit assessment of the counter party.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Performance letters of credit represent conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid or performance related contracts. The coverage period for these instruments is typically a one-year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized over the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

13. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

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

	December 31,			
	2004	Estimated	2003	Estimated
	Carrying	Fair Value	Carrying	Fair Value
	Amount		Amount	
Financial assets:				
Cash and due from banks	\$ 9,339	\$ 9,339	\$ 9,951	\$ 9,951
Available-for-sale securities	95,747	95,747	106,587	106,587
Net loans	355,774	362,672	314,037	322,813
Bank owned life insurance	7,449	7,449	7,142	7,142
Regulatory stock	2,769	2,769	2,540	2,540
Accrued interest receivable	1,736	1,736	1,703	1,703
Financial liabilities:				
Deposits	\$ 419,074	\$ 420,878	\$ 385,691	\$ 391,282
Borrowed funds	34,975	34,952	35,296	35,498
Accrued interest payable	1,870	1,870	1,888	1,888

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 DUE FROM BANKS:

The carrying amounts for cash and due from banks approximate fair value because they mature in 90 days or less 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.

14. GOODWILL

A summary of goodwill is as follows (in thousands):

		December 31,		
	2004	2003	2002	
Beginning carrying amount	\$ 7,685	\$ 7,685	\$ 7,685	
Add: amount related to acquisition	1,700	-	-	
Gross carrying amount	9,385	7,685	7,685	
Less: accumulated amortization	780	780	780	
Net carrying amount	\$ 8,605	\$ 6,905	\$ 6,905	

The gross carrying amount of goodwill is tested for impairment on an annual basis. Due to an increase in overall earning asset growth, operating profits and cashflows were greater than expected. Based on the fair value of the reporting unit, estimated using the expected present value of future cashflows, no goodwill impairment loss was recognized in 2004, 2003 or 2002.

15. CORE DEPOSIT INTANGIBLE ASSETS

A summary of core deposit intangible assets is as follows (in thousands):

		December 31,		
	2004	2003	2002	
Beginning carrying amount	\$ 2,763	\$ 2,763	\$ 2,763	
Add: amount related to acquisition	790	-	-	
Gross carrying amount	3,553	2,763	2,763	
Less: accumulated amortization	2,291	1,785	1,350	
Net carrying amount	\$ 1,262	\$ 978	\$ 1,413	

Amortization expense amounted to \$506,000, \$435,000 and \$457,000 for 2004, 2003 and 2002, respectively.

The estimated amortization expense of intangible assets for each of the five succeeding fiscal years is as follows (in thousands):

	Core deposit intangibles
For the year ended December 31, 2005	\$ 578
For the year ended December 31, 2006	252
For the year ended December 31, 2007	144
For the year ended December 31, 2008	144
For the year ended December 31, 2009	144

16. CONDENSED FINANCIAL INFORMATION - PARENT COMPANY ONLYCITIZENS FINANCIAL SERVICES, INC.
CONDENSED BALANCE SHEET

<i>(in thousands)</i>	December 31,	
	2004	2003
Assets:		
Cash	\$ 7,549	\$ 7,680
Investment in subsidiary, First Citizens National Bank	40,317	39,241
Other assets	497	306
Total assets	\$ 48,363	\$ 47,227
Liabilities:		
Other liabilities	\$ 74	\$ 260
Borrowed funds	7,500	8,438
Total liabilities	7,574	8,698
Stockholders' equity	40,789	38,529
Total liabilities and stockholders' equity	\$ 48,363	\$ 47,227

CITIZENS FINANCIAL SERVICES, INC.
CONDENSED STATEMENT OF INCOME

<i>(in thousands)</i>	Year Ended December 31,		
	2004	2003	2002
Dividends from:			
Bank subsidiary	\$ 3,776	\$ 4,142	\$ 1,478
Available-for-sale securities	-	3	19
Interest-bearing deposits with banks	-	-	2
Total income	3,776	4,145	1,499
Investment securities gains, net	-	150	178
Expenses	377	186	213
Income before equity in undistributed earnings of subsidiary	3,399	4,109	1,464
Equity in undistributed earnings - First Citizens National Bank	1,868	770	4,131
Net income	\$ 5,267	\$ 4,879	\$ 5,595

CITIZENS FINANCIAL SERVICES, INC.
STATEMENT OF CASH FLOWS

<i>(in thousands)</i>	Year Ended December 31,		
	2004	2003	2002
Cash flows from operating activities:			
Net income	\$ 5,267	\$ 4,879	\$ 5,595
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	(1,868)	(770)	(4,131)
Investment securities gains, net	-	(150)	(178)
Other, net	(377)	(55)	12
Net cash provided by operating activities	3,022	3,904	1,298
Cash flows from investing activities:			
Proceeds from the sale of available-for-sale securities	-	429	621
Net cash provided by investing activities	-	429	621
Cash flows from financing activities:			
Cash dividends paid	(2,209)	(2,103)	(1,918)
Proceeds from borrowed funds	-	8,555	-
Repayments of borrowed funds	(938)	(2,117)	-
Purchase of treasury stock	(6)	(1,056)	-
Net cash (used in) provided by financing activities	(3,153)	3,279	(1,918)
Net (decrease) increase in cash	(131)	7,612	1
Cash at beginning of year	7,680	68	67
Cash at end of year	\$ 7,549	\$ 7,680	\$ 68

17. CONDENSED QUARTERLY DATA**CONSOLIDATED QUARTERLY DATA**

(dollar amounts in thousands, except share data)

	Three Months Ended			
2004	Mar 31	Jun 30	Sep 30	Dec 31
Interest income	\$ 6,393	\$ 6,431	\$ 6,855	\$ 6,927
Interest expense	2,177	2,209	2,379	2,470
Net interest income	4,216	4,222	4,476	4,457
Provision for loan losses	-	-	-	-
Non-interest income	1,107	1,172	1,153	1,095
Investment securities gains (losses), net	287	204	-	(726)
Non-interest expenses	3,671	3,675	3,780	3,796
Income before provision for income taxes	1,939	1,923	1,849	1,030
Provision for income taxes	447	456	426	145
Net income	\$ 1,492	\$ 1,467	\$ 1,423	\$ 885
Earnings Per Share	\$ 0.52	\$ 0.52	\$ 0.50	\$ 0.31

	Three Months Ended			
2003	Mar 31	Jun 30	Sep 30	Dec 31
Interest income	\$ 6,520	\$ 6,401	\$ 6,329	\$ 6,365
Interest expense	2,313	2,264	2,149	2,100
Net interest income	4,207	4,137	4,180	4,265
Provision for loan losses	135	120	120	60
Non-interest income	1,095	1,270	1,212	1,182
Investment securities gains, net	259	141	114	39
Non-interest expenses	3,631	3,631	4,490	3,749
Income before provision for income taxes	1,795	1,797	896	1,677
Provision for income taxes	430	415	90	351
Net income	\$ 1,365	\$ 1,382	\$ 806	\$ 1,326
Earnings Per Share	\$ 0.47	\$ 0.48	\$ 0.28	\$ 0.47

18. ACQUISITION

On June 4, 2004, the Bank acquired two leased banking facilities of The Legacy Bank located in the Towanda and Sayre areas, known hereafter as the "Acquisition". This Acquisition included loans of \$27,340,000, retail core deposits of \$20,663,000 and certain fixed assets. This transaction was accounted for under the purchase method and the Bank recorded \$2,490,000 of intangible assets. As part of the Acquisition we elected to consolidate the newly acquired Towanda Legacy office into our existing Towanda branch, thus not assuming the existing lease. We also elected to close our existing Sayre branch located on Keystone Avenue and consolidate our current customers into the new Sayre location on Elmira Street. The consolidated results include the operations of the acquired banking offices from the date of acquisition. On July 15, 2004, subsequent to the Acquisition, the Elmira Street property was purchased, which was previously leased by The Legacy Bank. This property includes space for branch operations, as well as three other units which are leased to outside parties. The lease income from these units is included in other income.

To the Stockholders and the Board of Directors of
Citizens Financial Services, Inc.

We have audited the consolidated balance sheet of Citizens Financial Services, Inc. and subsidiary as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citizens Financial Services, Inc. and subsidiary as of December 31, 2004 and 2003, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

Wexford, Pennsylvania
January 21, 2005

S.R. Snodgrass, A.C.
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Phone: 724-934-0344 • Facsimile: 724-934-0345

FIVE YEAR SUMMARY OF OPERATIONS

*(dollar amounts in thousands, except
share data)*

	2004	2003	2002	2001	2000
Interest income	\$ 26,606	\$ 25,615	\$ 27,377	\$ 29,025	\$ 26,226
Interest expense	9,235	8,826	10,404	14,306	14,238
Net interest income	17,371	16,789	16,973	14,719	11,988
Provision for loan losses	-	435	435	445	610
Net interest income after provision					&nb