CITIZENS FINANCIAL SERVICES INC
Form ARS
March 14, 2006

This past year was one of challenges, accomplishments and excitement for your Company, Citizens Financial Services, Inc. We expanded into a new market and made investments for future expansion in existing markets. In addition, we increased our focus on customer expectations and renewed our commitment to the agricultural community. Our partnership with our communities has never been stronger.

We continue to follow through on our commitment to build a stronger, more diversified and valuable Company, while holding true to the values of a true community bank. In 2005, we continued to refine and sharpen our customer, employee and corporate strategies to create an environment where customers are understood and valued, employees are engaged and appreciated, and the shareholders are rewarded. I am proud to report that 2005 was a year in which significant strides were made in accomplishing our strategic objectives.

We truly believe that the key to our success, not just for 2005, but beyond, is creating customer loyalty by employing talented and enthusiastic people who proactively look out for our customers’ best interests. We are committed to having highly trained professionals who are ready to satisfy each customer’s specific financial needs through our retail network, commercial business group, or our wealth management team.

In the fourth quarter of 2005, your Company achieved a significant milestone when we expanded our banking footprint by opening our first New York State office. In December, we acquired the Hannibal office of Fulton Savings Bank and relocated that office to Wellsville, New York. We have been serving the Wellsville market for many years through our Genesee office. The economic and social characteristics of Wellsville make it a perfect addition to our community office network. Plans are well under way to build a permanent facility at the Wellsville location this year. I encourage you to read more about our Wellsville initiatives on page 7 of this annual report.

Throughout 2005, we continued to build momentum in the wealth management area by leveraging our employee knowledge and experience. Our trust officers bring a combined 75 plus years experience to every situation. I’m proud to report that trust assets grew to over $75 million, an increase of 11.5% over the prior year. Also, brokerage and insurance revenue grew 23% in 2005, due in large part to the ability of our community office staff to satisfy customer needs with wealth management services.

The commitment to our customer, employee and shareholder strategies resulted in strong financial performance for the year despite a difficult and complicated economic environment for banking. This is especially gratifying for us as we compare our performance this past year to our local peer banks year-to-year performance. In 2005 Citizens Financial Services, Inc., along with other financial organizations, faced a less than favorable interest rate environment. A flattened yield curve created pressure on banks to deviate from their traditional pricing strategies. Our strategic planning process allowed us to recognize

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pricing challenges and develop a methodology to support our goals. This strategy, along with the successful execution of the growth initiatives outlined in our plan, has resulted in a solid year in terms of financial performance and provides a strong foundation for our future. Total assets increased $29.9 million to $529.2 million, an increase of 6.0% over last year. Total deposits grew 2.6% while total loans grew 6.4% to $429.8 million and $379.1 million, respectively. Stockholders' equity increased $2.5 million, or 6.1% over the prior year, excluding accumulated other comprehensive income.

Consolidated net income for the year was $5,274,000 compared to $5,267,000 in 2004, an increase of .1%. Earnings per share were $1.85, which represents a slight increase of .5% over 2004 earnings per share of $1.84. The year-end results included approximately $240,000 of non-recurring expenses which were incurred as a result of our New York State expansion. Cash dividends paid in 2005 totaled $.82 per share which represented an increase of 5.1% over 2004. As of December 31, 2005, this represented a dividend yield of approximately 4%, which ranked us in the top 20 of publicly traded banks in Pennsylvania for 2005.

I am pleased to report that our asset quality remains at a very high level and continues to strengthen. During 2005, we experienced net charge-offs of $315,000 representing .08% of average loans, which compares with .00% in 2004 and .14% in 2003. This compares favorably to our peer group. Another critical measurement of asset quality is the classified asset ratio. This ratio involves non-performing assets defined as loans greater than ninety days past due and assets acquired through foreclosure, over regulatory capital. At year end, our classified asset ratio was 20.1% compared to 24.7% in 2004. This compares favorably to the benchmark for the industry of 25%.

As we move forward in 2006, we will be focused on the continued growth and expansion of our banking franchise, while not losing sight of the core values associated with being a true community bank. Our increased focus on the agricultural community will play a significant role in accomplishing our small business initiatives as we strive for continued organic growth. We see tremendous opportunities within the agriculture industry due not only to the fact that farming accounts for a large portion of the businesses in our markets, but also to the fact that we have extensive farming experience within our employee base. Our Ag Banking Team, led by Brian Dygert and Chris Landis, has 115 combined years in farming and 98 years in Ag Banking experience. We intend to leverage this extensive knowledge and experience to keep farming alive in our market place. More details on our Ag Banking initiatives can be found on page 6 of this annual report.

Although the economy will present another challenging year, we continue to be very positive about the future of your Company and the opportunities that lie ahead.

I'd like to thank the Board of Directors for their guidance and resolution to remain an independent, community bank. I'd like to thank our employees, the foundation of First Citizens and our competitive strength, for their excitement and dedication, day in and day out. And, I would like to thank you, our shareholders, for your continued dedication and loyalty to Citizens Financial Services, Inc. and for being ambassadors of First Citizens National Bank.

Randall E. Black
CEO & President

Old Traditions...
Our renewed focus on Farming

According to the 2002 Census of Agriculture, there are 3,678 farms operating in the four counties that we serve. This is exciting news for First Citizens as we have a significant depth of agricultural knowledge and experience within our staff to serve this industry.

Our approach to serving the farming industry is to have highly skilled Business Development Officers who have a clear understanding of our customers' business, as well as, what is happening in the industry as a whole. We have been successfully employing this approach with small businesses throughout our market for many years. We believe we can leverage the expertise of our newly formed Ag Team, with information we acquire through organized focus groups and daily customer interaction, to position First Citizens as the preferred partner to farmers.

Creating loyalty will depend heavily on our commitment to proactively look out for our customer's best interest, and we intend to do just that. Our Ag Team is just one component of a plan that has been developed to advance our focus on Agriculture. We have other exciting initiatives underway to assist farmers with the successful operation of their farms.

New Beginnings...

First Citizens National Bank enters the New York Market

First Citizens has been serving the Wellsville market for many years through our Genesee office, located just 10 miles away. Abbie Pritchard, who currently manages our Genesee and Wellsville offices, has been successful in building a positive image for First Citizens and opening the doors to the Wellsville market. Based on her success and the capacity within the market for growth, we decided it was time to take our efforts to the next level.

Wellsville is the largest town in Allegany County, New York with approximately 485 businesses operating in the region. Our decision to place an office in Wellsville was made with the understanding that we would focus heavily on attracting and creating loyal small business customers.

We began by talking to groups of small business owners and managers. We also shopped our competition. Our findings greatly support the need in this community for a financial institution of our size - not too big so personal service gets lost and not too small to be limited on the products, services and expertise we can provide.

Our success as a financial institution has been based on building customer loyalty which we believe comes from using the knowledge that we have learned about our customers and their needs to proactively provide solutions. We believe our continued practice of this strategy will give us the competitive advantage to succeed in the Wellsville market.

Jean Knapp
Assistant Vice President, Trust Officer

Jean Knapp has been providing advice and comfort to Trust customers of First Citizens National Bank for over 25 years. And according to long-time customers James and Betty Rieppel, comfort is her greatest gift. In Betty's words, "Jean is always looking out for our best interest. This, along with her extensive knowledge and experience is a great comfort to us."

Jean's experience with Estate Administration is one of her greatest strengths. In the last several years, she has managed over 20 estates ensuring peace between family members while satisfying the wishes of the deceased. Jean's passion comes from solving problems, even when they aren't necessarily related to banking. According to Jean, "When I can resolve a situation for a customer and they rest comfortably, even if it involves finding someone to plow snow or do home improvements, I'm satisfied."

Terry Osborne
Executive Vice President, Banking Services

Terry Osborne is a 30-year veteran of First Citizens. He began as manager of our Genesee Office and moved through the community office network before becoming the bank's top authority on loans and ultimately, Executive Vice President. Terry has received many accolades throughout his career for his accomplishments at First Citizens, his work with the Pennsylvania Bankers Association, and has received honors from various high level banking schools. He believes in giving back to his community as Director of the Southern Tioga School District, Chairman of the Blossburg Recreational Board and Sunday School Teacher.

Terry credits his success at First Citizens to working with a team of outstanding employees who share his desire to serve both customer and community, and is grateful for the personal growth opportunities provided him by the Board of Directors and management of First Citizens over the years.

Gail Gunther
Customer Service Associate

Gail joined the Sayre Lockhart Street office in 1990 through the acquisition of the Star Savings Bank where she worked since 1981. She has a never-ending desire to care for her customers. Mary “Mickey” Olisky has been doing business with Gail for almost 20 years and chose these words to describe her: “She is an extremely caring and genuine individual, bright and reliable with a wonderful sense of humor. I have complete trust that if she’s giving me advice, it is in my best interest.”

Gail takes her responsibilities related to understanding customer needs and finding solutions to heart. When First Citizens began offering Investment products, Gail became the company’s strongest advocate believing customers have a right to make educated choices about their future.

When asked what gives her the greatest satisfaction, Gail responded, “I’m most pleased when I can lead a customer in a direction they may not have considered to satisfy their need. It’s not the customer’s job to always have the solution, but it is mine. If I don’t have an answer, it’s my job to find one. I feel

satisfied when I believe both the
customer and the bank win.”

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 t 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 share holder 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, **2005**	2004
ASSETS:		
Cash and cash equivalents:		
Noninterest-bearing	**$ 8,498**	$ 9,162
Interest-bearing	**111**	177
Total cash and cash equivalents	**8,609**	9,339
Available-for-sale securities	**102,602**	95,747
Loans (net of allowance for loan losses		
2005, $3,664; 2004, $3,919)	**379,139**	355,774
Premises and equipment	**12,305**	11,833
Accrued interest receivable	**2,164**	1,736
Goodwill	**8,605**	8,605
Core deposit intangible	**684**	1,262
Bank owned life insurance	**7,743**	7,449
Other assets	**7,390**	7,602
TOTAL ASSETS	**$ 529,241**	$ 499,347
LIABILITIES:		
Deposits:		
Noninterest-bearing	**$ 50,600**	$ 46,866
Interest-bearing	**379,199**	372,208
Total deposits	**429,799**	419,074
Borrowed funds	**52,674**	34,975
Accrued interest payable	**1,862**	1,870
Commitment to purchase investment securities	**752**	-
Other liabilities	**2,593**	2,639
TOTAL LIABILITIES	**487,680**	458,558
STOCKHOLDERS' EQUITY:		
Common Stock		
$1.00 par value; authorized 10,000,000 shares;		
issued 2,965,257 and 2,937,519		
shares in 2005 and 2004, respectively	**2,965**	2,938
Additional paid-in capital	**11,359**	10,804
Retained earnings	**31,251**	28,894
TOTAL	**45,575**	42,636
Accumulated other comprehensive (loss) income	**(1,540)**	164
Treasury stock, at cost		
118,715 and 97,262 shares for 2005 and 2004, respectively	**(2,474)**	(2,011)
TOTAL STOCKHOLDERS' EQUITY	**41,561**	40,789
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**$ 529,241**	$ 499,347

See accompanying notes to consolidated financial statements.

	Year Ended December 31,		
(in thousands, except per share data)	**2005**	2004	2003
INTEREST INCOME:			
Interest and fees on loans	**$ 24,911**	$ 22,600	$ 21,593
Interest-bearing deposits with banks	**3**	10	29
Investment securities:			
Taxable	**2,979**	3,413	3,222
Nontaxable	**596**	301	457
Dividends	**210**	282	314
TOTAL INTEREST INCOME	**28,699**	26,606	25,615
INTEREST EXPENSE:			
Deposits	**9,373**	8,283	8,501
Borrowed funds	**1,627**	952	325
TOTAL INTEREST EXPENSE	**11,000**	9,235	8,826
NET INTEREST INCOME	**17,699**	17,371	16,789
Provision for loan losses	**60**	-	435
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**17,639**	17,371	16,354
NON-INTEREST INCOME:			
Service charges	**2,965**	3,017	3,018
Trust	**474**	434	422
Brokerage	**183**	185	200
Insurance	**260**	175	209
Gains on loans sold	**70**	54	349
Investment securities (losses) gains, net	**-**	(235)	553
Earnings on bank owned life insurance	**294**	307	142
Other	**442**	355	419
TOTAL NON-INTEREST INCOME	**4,688**	4,292	5,312
NON-INTEREST EXPENSES:			
Salaries and employee benefits	**7,645**	7,636	8,304
Occupancy	**1,142**	1,072	1,025
Furniture and equipment	**658**	695	713
Professional fees	**536**	630	694
Amortization of intangibles	**578**	506	435
Other	**4,828**	4,383	4,330
TOTAL NON-INTEREST EXPENSES	**15,387**	14,922	15,501
Income before provision for income taxes	**6,940**	6,741	6,165
Provision for income taxes	**1,666**	1,474	1,286
NET INCOME	**$ 5,274**	$ 5,267	$ 4,879
NET INCOME - EARNINGS PER SHARE	**$ 1.85**	$ 1.84	$ 1.68
CASH DIVIDENDS PER SHARE	**$ 0.82**	$ 0.78	$ 0.74

See accompanying notes to consolidated financial statements.

(in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income(Loss)	Treasury Stock	Total
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
Comprehensive income:							
Net income				**5,274**			**5,274**
Change in unrecognized pension costs, net of tax benefit of $121					**(234)**		**(234)**
Change in net unrealized loss on securities available-for-sale, net of tax benefit of $758					**(1,470)**		**(1,470)**
Total comprehensive income							**3,570**
Stock dividend	**27,738**	**27**	**555**	**(582)**			
Purchase of treasury stock (21,453 shares)						**(463)**	**(463)**
Cash dividends, $.82 per share				**(2,335)**			**(2,335)**
Balance, December 31, 2005	**2,965,257**	**$ 2,965**	**$ 11,359**	**$ 31,251**	**$ (1,540)**	**$ (2,474)**	**$ 41,561**

2005	2004	2003

Components of comprehensive loss:					
Change in net unrealized loss on investment securities available-for-sale	**$**	**(1,470)**	$	(947)	$ (1,232)
Change in unrecognized pension costs		**(234)**		-	-
Investment losses (gains) included in net income, net of tax expense (benefit) of $0, $(80) and $188		**-**		155	(365)
Total	**$**	**(1,704)**	$	(792)	$ (1,597)

See accompanying notes to consolidated financial statements.

(in thousands)	Year Ended December 31, **2005**	2004	2003
Cash Flows from Operating Activities:			
Net income	**$ 5,274**	$ 5,267	$ 4,879
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	**60**	-	435
Depreciation and amortization	**1,327**	1,444	1,358
Amortization and accretion on investment securities	**712**	912	1,129
Deferred income taxes	**256**	(166)	(141)
Investment securities losses (gains), net	**-**	235	(553)
Earnings on bank owned life insurance	**(294)**	(307)	(142)
Realized gains on loans sold	**(70)**	(54)	(349)
Originations of loans held for sale	**(5,433)**	(3,048)	(22,435)
Proceeds from sales of loans held for sale	**5,503**	3,102	23,749
Decrease (increase) in accrued interest receivable	**(429)**	(33)	273
Decrease in accrued interest payable	**(8)**	(18)	(189)
Other, net	**917**	(167)	1,626
Net cash provided by operating activities	**7,815**	7,167	9,640
Cash Flows from Investing Activities:			
Available-for-sale securities:			
Proceeds from sales of available-for-sale securities	**-**	14,045	12,108
Proceeds from maturity and principal repayments of securities	**17,571**	24,571	49,343
Purchase of securities	**(27,366)**	(30,122)	(71,320)
Proceeds from redemption of Regulatory Stock	**2,702**	1,585	746
Purchase of Regulatory Stock	**(2,783)**	(1,814)	(1,757)
Net increase in loans	**(23,676)**	(15,405)	(20,819)
Purchase of loans	**-**	(27,340)	-
Purchase of bank owned life insurance	**-**	-	(7,000)
Purchase of premises and equipment	**(1,306)**	(2,319)	(490)
Proceeds from sale of premises and equipment	**200**	34	-
Deposit acquisition premium	**-**	(2,200)	-
Proceeds from sale of foreclosed assets held for sale	**486**	338	155
Net cash used in investing activities	**(34,172)**	(38,627)	(39,034)
Cash Flows from Financing Activities:			
Net increase in deposits	**10,300**	12,720	12,641
Proceeds from long-term borrowings	**8,594**	654	18,202
Repayments of long-term borrowings	**(3,471)**	(1,519)	(2,569)
Net increase in short-term borrowed funds	**12,577**	545	2,636
Dividends paid	**(2,335)**	(2,209)	(2,103)
Deposits of acquired branches	**425**	20,663	-
Purchase of treasury stock	**(463)**	(6)	(1,056)
Net cash provided by financing activities	**25,627**	30,848	27,751
Net decrease in cash and cash equivalents	**(730)**	(612)	(1,643)

Cash and Cash Equivalents at Beginning of Year		**9,339**		9,951		11,594
Cash and Cash Equivalents at End of Year	**$**	**8,609**	$	9,339	$	9,951
Supplemental Disclosures of Cash Flow Information:						
Interest paid	**$**	**10,973**	$	9,253	$	9,015
Income taxes paid	**$**	**1,150**	$	1,780	$	1,265
Noncash activities:						
Real estate acquired in settlement of loans	**$**	**369**	$	718	$	218
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 sixteen full-service banking offices in Potter, Tioga and Bradford counties, Pennsylvania and Allegany County, New York. 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 U.S. generally accepted accounting principles. All significant inter-company 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. Material estimates that are particularly susceptible to significant change relate to determination of the allowance for loan losses and deferred tax assets and liabilities.

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, 2005 and 2004.

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, 2005 and 2004.

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. When an other than temporary impairment occurs, the investment is written down to the current fair market value with the write-down being reflected as a realized 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 loans are carried at the lower of cost or fair value less 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 to income or charged to expense, respectively.

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, on average, over a 5 ½ 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 2005 or 2004.

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 PLAN

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 has a defined contribution, 401(k) plan covering eligible employees. The Company contributes a certain percentage of the eligible employee's compensation into the plan. The employee may also contribute to the plan on a voluntary basis, up to a maximum percentage allowable not to exceed the limits of Code Sections 401(k).

The Company also has a profit-sharing plan for employees which provide tax-deferred salary savings to plan participants. The Company has a deferred compensation plan for directors who have elected to defer all or portions of their fees until their retirement or termination from service.

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 of unrealized holding gains (losses) on the available-for-sale securities portfolio and unrecognized pension costs. 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 No. 123 (revised 2004), Share-Based Payment (FAS No. 123R). FAS No. 123R revised FAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. FAS No. 123R will require compensation costs related to share-based payment transactions to be recognized in the financial statement (with limited exceptions). The amount of compensation cost will be measured based on the grant-date fair value of the equity or liability instruments issued. Compensation cost will be recognized over the period that an employee provides service in exchange for the award.

In April 2005, the Securities and Exchange Commission adopted a new rule that amends the compliance dates for FAS No. 123R. The Statement requires that compensation costs relating to share-based payment transactions are recognized in financial statements and that this cost be measured based on the fair value of the equity or liability instruments issued. FAS No. 123R 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 Company will adopt FAS No. 123R on January 1, 2006. Presently, the Company's compensation strategy excludes share-based payments. As such, the estimated compensation expense will not be impacted by the adoption of this rule. The impact of this Statement on the Company in fiscal 2006 and beyond on the results of operation or financial condition will depend upon various factors, among them being our future compensation strategy with regards to share-based compensation.

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB No. 107"), Share-Based Payment, providing guidance on option valuation methods, the accounting for income tax effects of share-based payment arrangements upon adoption of FAS No. 123R, and the disclosures in Managements' Discussion and Analysis subsequent to the adoption. The Company will provide SAB No. 107 required disclosures upon adoption of FAS No. 123R on January 1, 2006.

In December 2004, FASB issued FAS No. 153, Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. FAS No. 153 amends Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of FAS No. 153 are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Early application is permitted and companies must apply the standard prospectively. 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 2005, the FASB issued FAS No. 154, Accounting Changes and Errors Corrections, a replacement of APB Opinion No. 20 and FAS No. 3. The Statement applies to all voluntary changes in accounting principle, and changes the requirements for accounting for and reporting of a change in accounting principle. FAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impractical. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. FAS No.154 improves the financial reporting because its requirements enhance the consistency of financial reporting between periods. The provisions of FAS No. 154 are effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

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, and are carried at cost.

TRUST ASSETS AND INCOME

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.

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 2,856,593, 2,868,131, and 2,897,041 for 2005, 2004 and 2003, 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 $814,000 and $833,000 at December 31, 2005 and 2004, 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, 2005 and 2004, were as follows (in thousands):

December 31, 2005	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Available-for-sale securities:				
U.S. Agency securities	**$ 12,955**	**$ -**	**$ (201)**	**$ 12,754**
Obligations of state and political subdivisions	**22,697**	**116**	**(201)**	**22,612**
Corporate obligations	**8,486**	**142**	**(1)**	**8,627**
Mortgage-backed securities	**57,345**	**84**	**(1,577)**	**55,852**
Equity securities	**3,099**	**-**	**(342)**	**2,757**
Total available-for-sale	**$ 104,582**	**$ 342**	**$ (2,322)**	**$ 102,602**

December 31, 2004	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
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

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, 2005 and 2004 (in thousands). As of December 31, 2005 and 2004, the Company owned 79 and 19 securities whose market value was less than their cost basis, respectively.

December 31, 2005	**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	**$ 8,754**	**$ 82**	**$ 4,000**	**$ 119**	**$ 12,754**	**$ 201**
Obligations of states and political subdivisions	**15,005**	**201**	**-**	**-**	**15,005**	**201**
Corporate obligations	**1,505**	**1**	**-**	**-**	**1,505**	**1**
Mortgage-backed securities	**9,470**	**109**	**44,350**	**1,468**	**53,820**	**1,577**
Total debt securities	**34,734**	**393**	**48,350**	**1,587**	**83,084**	**1,980**
Equity securities	**2,757**	**342**	**-**	**-**	**2,757**	**342**
Total securities	**$ 37,491**	**$ 735**	**$ 48,350**	**$ 1,587**	**$ 85,841**	**$ 2,322**

December 31, 2004	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.

For fixed maturity investments with unrealized losses due to interest rates where the Company has both the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery, declines in value below cost are not assumed to be other than temporary. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an other than temporary impairment unless sufficient evidence is available that the decline is not permanent 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 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 2005, 2004, and 2003 were $0, $14,045,000 and $12,108,000, respectively. Gross gains and gross losses were realized on those sales as follows (in thousands):

	2005	2004	2003
Gross gains	**$ -**	$ 517	$ 553
Gross losses	**-**	26	-
Net gains	**$ -**	$ 491	$ 553

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 $83,748,000 and $71,899,000 at December 31, 2005 and 2004, 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, 2005, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Estimated Fair Value
Available-for-sale securities:		
Due in one year or less	$ 6,518	$ 6,525
Due after one year through five years	35,352	34,828
Due after five years through ten years	27,312	26,523
Due after ten years	32,301	31,969
Total	$ 101,483	$ 99,845

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, 2005 and 2004, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions.
Major classifications of loans are as follows (in thousands):

	December 31, 2005	2004
Real estate loans:		
Residential	$ 195,628	$ 189,803
Commercial	82,128	75,228
Agricultural	12,991	11,564
Construction	7,245	7,282
Loans to individuals for household, family and other purchases	13,017	12,657
Commercial and other loans	29,260	28,069
State and political subdivision loans	42,534	35,090
	382,803	359,693
Less allowance for loan losses	3,664	3,919
Loans, net	$ 379,139	$ 355,774

Real estate loans serviced for Freddie Mac and Fannie Mae, which are not included in the consolidated balance sheet, totaled $36,306,000 and $34,514,000 at December 31, 2005 and 2004, respectively.
At December 31, 2005 and 2004, net unamortized loan fees and costs of $890,000 and $829,000, respectively, have been deducted from the carrying value of loans.

The Company had nonaccrual loans, inclusive of impaired loans, of $1,898,000 and $1,783,000 at December 31, 2005 and 2004, respectively. Interest income on loans would have increased by approximately $144,000, $87,000 and $166,000 during 2005, 2004 and 2003, 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):

	2005	2004	2003
Impaired loans without related allowance for loan losses	**$ 673**	$ 229	$ 1,197
Impaired loans with related allowance for loan losses	**358**	832	729
Related allowance for loan losses	**179**	6	35
Average recorded balance of impaired loans	**1,148**	1,091	1,772
Interest income recognized on impaired loans	**7**	18	35

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

	Year Ended December 31,		
	2005	2004	2003
Balance, beginning of year	**$ 3,919**	$ 3,620	$ 3,621
Provision charged to income	**60**	-	435
Increase related to acquisition	**-**	290	**-**
Recoveries on loans previously charged against the allowance	**57**	324	116
	4,036	4,234	4,172
Loans charged against the allowance	**(372)**	(315)	(552)
Balance, end of year	**$ 3,664**	$ 3,919	$ 3,620

The following is a summary of the past due and nonaccrual loans as of December 31, 2005 and 2004 (in thousands):

	December 31, 2005		
	Past Due 30 - 89 days	**Past Due 90 days or more**	**Nonaccrual**
Real estate loans	**$ 2,097**	**$ 298**	**$ 1,734**
Installment loans	**99**	**7**	**-**
Credit cards and related loans	**29**	**2**	**15**
Commercial and all other loans	**296**	**30**	**149**
Total	**$ 2,521**	**$ 337**	**$ 1,898**

	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

5. PREMISES & EQUIPMENT

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

	December 31,	
	2005	2004
Land	**$ 2,954**	$ 2,767
Buildings	**10,606**	10,484
Furniture, fixtures and equipment	**6,815**	6,765
Construction in process	**841**	56
	21,216	20,072
Less accumulated depreciation	**8,911**	8,239
Premises and equipment, net	**$ 12,305**	$ 11,833

Depreciation expense amounted to $798,000, $833,000 and $836,000 for 2005, 2004, and 2003, respectively.

6. GOODWILL

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

	December 31,	
	2005	2004
Beginning carrying amount	**$ 9,385**	$ 7,685
Add: amount related to acquisition	**-**	1,700
Gross carrying amount	**9,385**	9,385
Less: accumulated amortization	**780**	780
Net carrying amount	**$ 8,605**	$ 8,605

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 cash flows were greater than expected. Based on the fair value of the reporting unit, estimated using the expected present value of future cash flows, no goodwill impairment loss was recognized in 2005, 2004 or 2003.

7. CORE DEPOSIT INTANGIBLE ASSETS

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

	December 31,	
	2005	2004
Beginning carrying amount	**$ 3,553**	$ 2,763
Add: amount related to acquisition	**-**	790
Gross carrying amount	**3,553**	3,553
Less: accumulated amortization	**2,869**	2,291
Net carrying amount	**$ 684**	$ 1,262

Amortization expense amounted to $578,000, $506,000 and $435,000 for 2005, 2004 and 2003, respectively.

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

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
Total	$	684

8. DEPOSITS

Certificates of deposit of $100,000 or more amounted to $55,894,000 and $51,719,000 at December 31, 2005 and 2004, respectively. Interest expense on certificates of deposit of $100,000 or more amounted to $2,036,000, $1,843,000 and $1,618,000 for the years ended December 31, 2005, 2004, and 2003, respectively.

Following are maturities of certificates of deposit as of December 31, 2005 (in thousands):

2006	$ 96,509
2007	55,994
2008	26,031
2009	15,454
2010	19,379
Thereafter	1,349
Total certificates of deposit	$ 214,716

9. BORROWED FUNDS

(dollars in thousands)	Securities Sold Under Agreements to Repurchase(a)	TT&L Borrowings(b)	FHLB Advances(c)	Federal Funds Line (d)	Notes Payable(e)	Term Loans(f)	Total Borrowed Funds
2005							
Balance at December 31	**$ 7,610**	**$ 606**	**$ 21,958**	**$ -**	**$ 7,500**	**$ 15,000**	**$ 52,674**
Highest balance at any month-end	**9,476**	**2,592**	**21,958**	**-**	**7,500**	**18,000**	**59,526**
Average balance	**8,320**	**244**	**10,024**	**260**	**7,500**	**15,545**	**41,893**
Weighted average interest rate:							
Paid during the year	**3.63%**	**2.94%**	**3.37%**	**4.28%**	**6.17%**	**3.13%**	**3.32%**
As of year-end	**4.18%**	**3.84%**	**4.23%**	**0.00%**	**7.30%**	**3.24%**	**3.89%**
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%	0.00%	4.36%	2.14%	2.27%
As of year-end	2.93%	0.00%	2.21%	0.00%	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%	0.00%	4.03%	2.46%	2.24%
As of year-end	2.50%	0.69%	1.03%	0.00%	3.97%	2.05%	2.05%

(a) Securities sold under agreements to repurchase mature within 5 years. The carrying value of the underlying securities at December 31, 2005 and 2004 was $11,389,000 and $15,146,000, 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 $210,573,000, 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, 2005 and 2004, the approximate carrying value of the securities collateral was $56,985,000 and $66,651,000, respectively.

(d) Federal funds line consists of an unsecured line from a third party bank. These advances are short-term borrowings that bear interest at a rate .10 percent higher than the Federal funds rate as computed by the Federal Reserve Bank. The Company has a borrowing limit of $10,000,000, inclusive of any outstanding balances. No specific collateral is required to be pledged for these borrowings.

(e) 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, 2005 and 2004, the rate was 7.30% and 5.30%, 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.

(f) 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, 2005**	December 31, 2004
Variable:			
(g)	June 30, 2006	**$ -**	$ -
Fixed:			
1.81%	June 17, 2005	**-**	3,000
2.45%	June 19, 2006	**4,000**	4,000
2.76%	December 18, 2006	**3,000**	3,000
3.69%	February 26, 2007	**3,000**	-
3.82%	January 10, 2008	**3,000**	-
3.99%	February 25, 2009	**2,000**	-
Total term loans		**$ 15,000**	$ 10,000

(g)

Interest rate floats monthly based on the 1 month LIBOR +1.75%, the interest rate was 6.11% and 4.07% at December 31, 2005 and 2004, 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, 2005 (in thousands):

2006	$ 35,813
2007	4,238
2008	10,513
2009	2,000
2010	110
Total borrowed funds	$ 52,674

10. EMPLOYEE BENEFIT PLANS

Noncontributory Defined Benefit Pension Plan

The Bank sponsors a trusteed, 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	
	2005	2004
Change in benefit obligation		
Benefit obligation at beginning of year	**$ 5,784**	$ 4,785
Service cost	**361**	336
Interest cost	**325**	295
Amendments	**3**	(3)
Assumption change	**(112)**	498
Experience gain	**(55)**	-
Benefits paid	**(141)**	(127)
Benefit obligation at end of year	**6,165**	5,784
Change in plan assets		
Fair value of plan assets at beginning of year	**4,599**	4,014
Actual return on plan assets	**127**	253
Employer contribution	**336**	459
Benefits paid	**(141)**	(127)
Fair value of plan assets at end of year	**4,921**	4,599
Funded status	**(1,244)**	(1,185)
Transition adjustment	**-**	(10)
Unrecognized prior service cost	**29**	25
Additional minimum liability	**(382)**	-
Unrecognized net gain from past experience different from that assumed	**1,552**	1,540
(Accrued) prepaid benefit cost	**$ (45)**	$ 370

The accumulated benefit obligation for the defined benefit pension plan was $4,966,000 and $4,466,000 at December 31, 2005 and 2004, respectively.

Components of Net Periodic Benefit Cost (in thousands):

	Pension Benefits	
	2005	2004
Service cost	**$ 361**	$ 336
Interest cost	**325**	295
Return on plan assets	**(376)**	(332)
Net amortization and deferral	**59**	24
Net periodic benefit cost	**$ 369**	$ 323

Assumptions

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

	Pension Benefits	
	2005	2004
Discount rate	**5.75%**	5.75%
Rate of compensation increase	**3.00**	3.25

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

	Pension Benefits	
	2005	2004
Discount rate	**5.75%**	5.75%
Expected long-term return on plan assets	**8.00**	8.00
Rate of compensation increase	**3.00**	3.25

Plan Assets

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. The allocation of the pension plan assets, as summarized below, is determined on the basis of sound economic principles and is continually reviewed in light of changes in market conditions. The Bank's pension plan weighted-average asset allocations at December 31, 2005 and 2004, by asset category are as follows:

	Plan Assets at December 31	
	2005	2004
Equity securities	**70.5%**	67.4%
Debt securities	**28.3**	25.0
Other	**1.2**	7.6
Total	**100.0%**	100.0%

Equity securities include the Company's common stock in the amounts of $224,000 (4.6% of total plan assets) and $257,000 (5.6% of total plan assets) at December 31, 2005 and 2004, respectively.
The Bank expects to contribute $340,000 to its pension plan in 2006. Expected future benefit payments that the Bank estimates from its pension plan are as follows:

2006	$	142,714
2007		147,318
2008		171,864
2009		173,253
2010		208,728
Thereafter		1,279,679

Defined Contribution Plan
Prior to 2005, the Company sponsored a non-contributory, voluntary 401(k) savings plan which eligible employees could elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). Beginning in 2005, the plan was modified to become a contributory plan. Under the plan, the Company makes required contributions on behalf of the eligible employees and eligible employees could elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). The Company's contributions vest immediately. Contributions by the Company for 2005 totaled $200,000.

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 $35,000, $32,000 and $26,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

11. INCOME TAXES
The provision for income taxes consists of the following (in thousands):

	Year Ended December 31,					
	2005		2004		2003	
Currently payable	**$**	**1,410**	$	1,640	$	1,427
Deferred liability (asset)		**256**		(166)		(141)
Provision for income taxes	**$**	**1,666**	$	1,474	$	1,286

The following temporary differences gave rise to the net deferred tax assets at December 31, 2005 and 2004 (in thousands):

	2005	2004
Deferred tax assets:		
Allowance for loan losses	**$ 1,078**	$ 1,146
Deferred compensation	**564**	556
Merger & acquisition costs	**48**	49
Allowance for losses on available-for-sale securities	**247**	247
Foreclosed assets held for sale	**-**	7
Unrecognized pension cost	**121**	-
Unrealized losses on available-for-sale securities	**673**	**-**
Less valuation allowance	**(182)**	-
Total	**$ 2,549**	$ 2,005
Deferred tax liabilities:		
Unrealized gains on available-for-sale securities	**$ -**	$ (84)
Depreciation and amortization	**(275)**	(315)
Bond accretion	**(36)**	(29)
Pension expense	**(114)**	(126)
Loan fees and costs	**(115)**	(94)
Goodwill and core deposit intangibles	**(215)**	(170)
Investment tax credits	**(18)**	(28)
Mortgage servicing rights	**(70)**	(75)
Total	**(843)**	(921)
Deferred tax asset, net	**$ 1,706**	$ 1,084

A valuation allowance was established as of December 31, 2005 of $182,000. The allowance is for certain unrealized losses on available-for-sale securities, particularly the loss on the impairment charge for Freddie Mac preferred stock recognized in 2004. As of December 31, 2005, the Company did not have sufficient unrealized capital gains available to utilize the unrealized loss recognized on the Freddie Mac preferred stock. No valuation allowance was established at December 31, 2004.

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,		
	2005	2004	2003
Provision at statutory rates on			
pre-tax income	**$ 2,347**	$ 2,287	$ 2,096
Effect of tax-exempt income	**(748)**	(648)	(710)
Tax credits	**(130)**	(130)	(130)
Bank owned life insurance	**(100)**	(105)	(48)
Nondeductible interest	**75**	54	62
Valuation allowance	**182**	-	-
Other items	**40**	16	16
Provision for income taxes	**$ 1,666**	$ 1,474	$ 1,286
Statutory tax rates	**34%**	34%	34%
Effective tax rates	**24.1%**	21.9%	20.9%

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

	Year Ended December 31,	
	2005	2004
Balance, beginning of year	**$ 3,090**	$ 3,345
New loans	**1,272**	808
Repayments	**(1,898)**	(1,063)
Balance, end of year	**$ 2,464**	$ 3,090

13. 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 2006 without approval of the Comptroller of the Currency of approximately $4,788,000, plus the Bank's net income for 2006.

LOANS:

The Bank is subject to regulatory restrictions which limit its ability to loan funds to the Company. At December 31, 2005, the regulatory lending limit amounted to approximately $4,520,000.

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, 2005 and 2004, 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 (dollars in thousands):

	2005		2004	
	Amount	**Ratio**	Amount	Ratio
Total capital (to risk weighted assets)				
Company	**$ 44,731**	**12.88%**	$ 42,156	12.86%
For capital adequacy purposes	**27,793**	**8.00%**	26,215	8.00%
To be well capitalized	**34,741**	**10.00%**	32,768	10.00%
Tier I capital (to risk weighted assets)				
Company	**$ 41,067**	**11.82%**	$ 38,236	11.67%
For capital adequacy purposes	**13,897**	**4.00%**	13,107	4.00%
To be well capitalized	**20,845**	**6.00%**	19,661	6.00%
Tier I capital (to average assets)				
Company	**$ 41,067**	**8.04%**	$ 38,236	7.84%
For capital adequacy purposes	**20,440**	**4.00%**	19,504	4.00%
To be well capitalized	**25,551**	**5.00%**	24,379	5.00%

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

	2005		2004	
	Amount	**Ratio**	Amount	Ratio
Total capital (to risk weighted assets)				
Bank	**$ 37,203**	**10.72%**	$ 34,184	10.44%
For capital adequacy purposes	**27,771**	**8.00%**	26,190	8.00%
To be well capitalized	**34,714**	**10.00%**	32,738	10.00%

Tier I capital (to risk weighted assets)						
Bank	**$**	**33,538**	**9.66%**	$	30,265	9.24%
For capital adequacy purposes		**13,886**	**4.00%**		13,095	4.00%
To be well capitalized		**20,828**	**6.00%**		19,643	6.00%
Tier I capital (to average assets)						
Bank	**$**	**33,538**	**6.57%**	$	30,265	6.21%
For capital adequacy purposes		**20,430**	**4.00%**		19,491	4.00%
To be well capitalized		**25,537**	**5.00%**		24,364	5.00%

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

14. 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, 2005 and 2004, are as follows (in thousands):

	2005	2004
Commitments to extend credit	**$ 56,767**	$ 55,285
Standby letters of credit	**1,618**	1,528

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 a financial agreement between a customer and 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.

15. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

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

	December 31,			
	2005		2004	
	Carrying Amount	**Estimated Fair Value**	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	**$ 8,609**	**$ 8,609**	$ 9,339	$ 9,339
Available-for-sale securities	**102,602**	**102,602**	95,747	95,747
Net loans	**379,139**	**391,493**	355,774	362,672
Bank owned life insurance	**7,743**	**7,743**	7,449	7,449
Regulatory stock	**2,849**	**2,849**	2,769	2,769
Accrued interest receivable	**2,164**	**2,164**	1,736	1,736
Financial liabilities:				
Deposits	**$ 429,799**	**$ 426,966**	$ 419,074	$ 420,878
Borrowed funds	**52,674**	**52,426**	34,975	34,952
Accrued interest payable	**1,862**	**1,862**	1,870	1,870

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 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.

16. CONDENSED FINANCIAL INFORMATION - PARENT COMPANY ONLY

CITIZENS FINANCIAL SERVICES, INC.
CONDENSED BALANCE SHEET

(in thousands)	**December 31, 2005**	2004
Assets:		
Cash	**$ 7,095**	$ 7,549
Investment in subsidiary:		
First Citizens National Bank	**41,533**	40,317
Other assets	**453**	497
Total assets	**$ 49,081**	$ 48,363
Liabilities:		
Other liabilities	**$ 20**	$ 74
Borrowed funds	**7,500**	7,500
Total liabilities	**7,520**	7,574
Stockholders' equity	**41,561**	40,789
Total liabilities and stockholders' equity	**$ 49,081**	$ 48,363

CITIZENS FINANCIAL SERVICES, INC.
CONDENSED STATEMENT OF INCOME

(in thousands)	**Year Ended December 31, 2005**	2004	2003
Dividends from:			
Bank subsidiary	**$ 2,825**	$ 3,776	$ 4,142
Available-for-sale securities	**-**	-	3
Total income	**2,825**	3,776	4,145
Investment securities gains, net	**-**	-	150
Expenses	**470**	377	186
Income before equity in undistributed earnings of subsidiary	**2,355**	3,399	4,109
Equity in undistributed earnings - First Citizens National Bank	**2,919**	1,868	770
Net income	**$ 5,274**	$ 5,267	$ 4,879

CITIZENS FINANCIAL SERVICES, INC.
STATEMENT OF CASH FLOWS

(in thousands)	**Year Ended December 31, 2005**	2004	2003
Cash flows from operating activities:			
Net income	**$ 5,274**	$ 5,267	$ 4,879
Adjustments to reconcile net income to net			
cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	**(2,919)**	(1,868)	(770)
Investment securities gains, net	**-**	-	(150)
Other, net	**(11)**	(377)	(55)
Net cash provided by operating activities	**2,344**	3,022	3,904
Cash flows from investing activities:			
Proceeds from the sale of available-for-sale securities	**-**	-	429
Net cash provided by investing activities	**-**	-	429
Cash flows from financing activities:			
Cash dividends paid	**(2,335)**	(2,209)	(2,103)
Proceeds from borrowed funds	**-**	-	8,555
Repayments of borrowed funds	**-**	(938)	(2,117)
Purchase of treasury stock	**(463)**	(6)	(1,056)
Net cash (used in) provided by financing activities	**(2,798)**	(3,153)	3,279
Net (decrease) increase in cash	**(454)**	(131)	7,612
Cash at beginning of year	**7,549**	7,680	68
Cash at end of year	**$ 7,095**	$ 7,549	$ 7,680

17. CONSOLIDATED CONDENSED QUARTERLY DATA

(in thousands, except share data)	**Three Months Ended**			
2005	**Mar 31**	**Jun 30**	**Sep 30**	**Dec 31**
Interest income	**$ 6,880**	**$ 7,033**	**$ 7,266**	**$ 7,520**
Interest expense	**2,547**	**2,635**	**2,799**	**3,019**
Net interest income	**4,333**	**4,398**	**4,467**	**4,501**
Provision for loan losses	**-**	**-**	**30**	**30**
Non-interest income	**1,110**	**1,135**	**1,231**	**1,228**
Investment securities gains (losses), net	**-**	**-**	**-**	**-**
Non-interest expenses	**3,831**	**3,862**	**3,821**	**3,889**
Income before provision for income taxes	**1,612**	**1,671**	**1,847**	**1,810**
Provision for income taxes	**345**	**358**	**529**	**434**
Net income	**$ 1,267**	**$ 1,313**	**$ 1,318**	**$ 1,376**
Earnings Per Share	**$ 0.45**	**$ 0.46**	**$ 0.46**	**$ 0.48**

	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	$ 0.51	$ 0.50	$ 0.31

18. ACQUISITIONS

On December 17, 2005, the Bank acquired the Hannibal branch of the Fulton Savings Bank located in Hannibal, New York. Simultaneous with the purchase, the branch was closed and relocated to Wellsville, New York. The acquisition included retail deposits of $425,000 and certain fixed assets. Costs associated with this purchase totaled $240,000. The consolidated operating results include these expenses as well operations of the de novo office in Wellsville from the date of start-up.

On June 4, 2004, the Bank acquired two leased banking facilities of The Legacy Bank located in the Towanda and Sayre areas. 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 transaction 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, 2005 and 2004, 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, 2005. 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 audits provide 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, 2005 and 2004, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

Wexford, Pennsylvania
January 27, 2006

FIVE YEAR SUMMARY OF OPERATIONS

(in thousands, except share data)	**2005**	2004	2003	2002	2001
Interest income	**$ 28,699**	$ 26,606	$ 25,615	$ 27,377	$ 29,025
Interest expense	**11,000**	9,235	8,826	10,404	14,306
Net interest income	**17,699**	17,371	16,789	16,973	14,719
Provision for loan losses	**60**	-	435	435	445
Net interest income after provision for loan losses	**17,639**	17,371	16,354	16,538	14,274
Non-interest income	**4,688**	4,527	4,759	4,792	3,632
Investment securities (losses) gains, net	**-**	(235)	553	254	657
Non-interest expenses	**15,387**	14,922	15,501	14,226	14,041
Income before provision for income taxes and extraordinary item	**6,940**	6,741	6,165	7,358	4,522
Provision for income taxes	**1,666**	1,474	1,286	1,763	765
Net income	**$ 5,274**	$ 5,267	$ 4,879	$ 5,595	$ 3,757
Per share data:					
Net income (1)	**$ 1.85**	$ 1.84	$ 1.68	$ 1.92	$ 1.29
Cash dividends (1)	**0.82**	0.78	0.74	0.67	0.62
Book value (1) (2)	**15.14**	14.16	13.10	12.32	11.06
Total investments	**$ 102,602**	$ 95,747	$ 106,587	$ 100,725	$ 113,604
Loans, net (3)	**379,139**	355,774	314,037	294,836	268,464
Total assets (3)	**529,241**	499,347	463,878	432,658	421,110
Total deposits (3)	**429,799**	419,074	385,691	373,051	370,474
Stockholders' equity	**41,561**	40,789	38,529	38,406	33,389

(1) Amounts were adjusted to reflect stock dividends.
(2) Calculation excludes accumulated other comprehensive income and unrecognized pension cost.
(3) Amounts in 2004 reflect the acquisition of branches in the second quarter of 2004.
Amounts in 2005 reflect the branch acquisition in the fourth quarter of 2005.

COMMON STOCK

Common stock issued by Citizens Financial Services, Inc. is traded in the local over-the-counter market, primarily in Pennsylvania and New York. Prices presented in the table below are bid prices between broker-dealers published by the National Association of Securities Dealers through the NASD OTC "Bulletin Board", its automated quotation system for non-NASDAQ quoted stocks and the National Quotation Bureau's "Pink Sheets." The prices do not include retail markups or markdowns or any commission to the broker-dealer. The bid prices do not necessarily reflect prices in actual transactions. Cash dividends are declared on a quarterly basis and the effects of stock dividends have been stated retroactively in the table below (also see dividend restrictions in Note 13 of the consolidated financial statements).

	2005		**Dividends declared per share**	2004		Dividends declared per share
	High	**Low**		High	Low	
First quarter	**$ 24.75**	**$ 23.50**	**$ 0.200**	$ 25.15	$ 23.55	$ 0.190
Second quarter	**24.80**	**20.75**	**0.205**	24.75	22.10	0.195
Third quarter	**21.95**	**20.10**	**0.205**	22.30	21.20	0.195
Fourth quarter	**21.25**	**19.50**	**0.210**	24.00	21.50	0.200

TRUST AND INVESTMENT SERVICES UNDER MANAGEMENT

(market values - in thousands)	**2005**	2004
INVESTMENTS:		
Bonds	**$ 15,913**	$ 11,178
Stock	**21,894**	22,170
Savings and Money Market Funds	**8,974**	13,062
Mutual Funds	**26,547**	18,923
Mortgages	**1,136**	1,173
Real Estate	**751**	925
Miscellaneous	**19**	28
Cash	**11**	-
TOTAL	**$ 75,245**	$ 67,459
ACCOUNTS:		
Estates	**$ -**	$ 962
Trusts	**24,538**	25,360
Guardianships	**126**	117
Employee Benefits	**25,822**	24,834
Investment Management	**21,368**	15,778
Custodial	**3,391**	408
TOTAL	**$ 75,245**	$ 67,459

CAUTIONARY STATEMENT

Forward-looking statements may prove inaccurate. We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of Citizens Financial Services, Inc., First Citizens National Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use such words as “believes,” “expects,” “anticipates,” or similar expressions, we are making forward-looking statements. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements:

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

INTRODUCTION

The following is management’s discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for Citizens Financial Services, Inc., a bank holding company and its subsidiary (the “Company”). Our Company’s consolidated financial condition and results of operations consist almost entirely of our wholly owned subsidiary’s (First Citizens National Bank) financial conditions and results of operations. Management’s discussion and analysis should be read in conjunction with the audited consolidated financial statements and related notes. Except as noted, tabular information is presented in thousands of dollars.

Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 16 banking facilities. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, the Wellsboro Weis Market store, and the Mansfield Wal-Mart Super Center. In December, we received regulatory approval to purchase the Hannibal branch of the Fulton Savings Bank in Hannibal, New York. Upon consummating the transaction, the office was relocated to Wellsville, New York. This marks the Company’s first office location in New York, and demonstrates success in achieving one of our primary strategic goals of expansion into New York.

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

Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the direction and frequency of changes in interest rates. Interest rate risk results from various re-pricing frequencies and the maturity structure of the financial instruments owned by the Company. The Company uses its asset/liability and funds management policy to control and manage interest rate risk.

Credit risk represents the possibility that a customer may not perform in accordance with contractual terms. Credit risk results from loans with customers and the purchasing of securities. The Company’s primary credit risk is in the loan portfolio. The Company manages credit risk by adhering to an established credit policy and through a disciplined evaluation of the adequacy of the allowance for loan losses. Also, the investment policy limits the amount of credit risk that may be taken in the investment portfolio.

Liquidity risk represents the inability to generate or otherwise obtain funds at reasonable rates to satisfy commitments to borrowers and obligations to depositors. The Company has established guidelines within its asset/liability and funds management policy to manage liquidity risk. These guidelines include, among other things, contingent funding alternatives.

Regulatory risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company and its subsidiary. We can not predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.

Readers should carefully review the risk factors described in other documents our Company files from time to time with the Securities and Exchange Commission, including the quarterly reports on Form 10-Q and any current reports on Form 8-K filed by us.

We face strong competition in the communities that we serve from other commercial banks, savings banks, and savings and loan associations, some of which are substantially larger institutions than our subsidiary. In addition, insurance companies, investment-counseling firms, and other business firms and individuals offer personal and corporate trust services. We also compete with credit unions, issuers of money market funds, securities brokerage firms, consumer finance companies, mortgage brokers and insurance companies. These entities are strong competitors for virtually all types of financial services.

In recent years, the financial services industry has experienced tremendous change to competitive barriers between bank and non-bank institutions. We must compete with traditional financial institutions, other business corporations that have begun to deliver competing financial services, and banking services that are easily accessible through the internet. Competition for banking services is based on price, nature of product, quality of service, and in the case of certain activities, convenience of location.

TRUST AND INVESTMENT SERVICES

Our Investment and Trust Services Department is committed to helping our customers meet their financial goals. The Trust Department offers professional trust administration, investment management services, estate planning and administration, and custody of securities. We also help the members of our communities prepare for retirement by providing retirement plans for local employers and by managing individual IRA accounts. Assets held by the 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. As of December 31, 2005, the Trust Department had $75.2 million of assets under management. This compares to $67.5 million as of December 31, 2004.

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

RESULTS OF OPERATIONS

Net income for the twelve months ending December 31, 2005 was $5,274,000, which represents a slight increase of $7,000 when compared to the 2004 related period. Net income for the twelve months ending December 31, 2004 totaled $5,267,000, an increase of $388,000 or 8.0% from the 2003 related period. Earnings per share were $1.85, $1.84 and $1.68 for the years ended 2005, 2004 and 2003, respectively. The reasons for these changes are discussed on the following pages.

The following table sets forth certain performance ratios of our Company for the periods indicated:

	2005	2004	2003
Return on Assets (net income to average total assets)	**1.04%**	1.09%	1.11%
Return on Equity (net income to average total equity)	**12.63%**	13.40%	13.22%
Dividend Payout Ratio (dividends declared divided by net income)	**44.28%**	41.90%	43.10%
Equity to Asset Ratio (average equity to average total assets)	**8.20%**	8.15%	8.43%

Net income is influenced by five key components: net interest income, non-interest income, non-interest expenses, provision for loan losses and the provision for income taxes. A discussion of these components follows.

NET INTEREST INCOME

The most significant source of revenue is net interest income; the amount of interest earned on interest-earning assets exceeding interest incurred on interest-bearing liabilities. Factors that influence net interest income are changes in volume of interest-earning assets and interest-bearing liabilities as well as changes in the associated interest rates.

The following table sets forth our Company's 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 (dollars in thousands):

Analysis of Average Balances and Interest Rates (1)

	2005			2004			2003		
	Average Balance (1)	**Interest**	**Average Rate**	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
	$	**$**	**%**	$	$	%	$	$	%
ASSETS									
Short-term investments:									
Interest-bearing deposits at banks	**114**	**3**	**2.63**	986	10	1.01	2,987	29	0.97
Total short-term investments	**114**	**3**	**2.63**	986	10	1.01	2,987	29	0.97
Investment securities:									
Taxable	**83,787**	**3,236**	**3.86**	97,595	3,779	3.87	82,048	3,633	4.43
Tax-exempt (3)	**14,705**	**903**	**6.14**	6,881	456	6.63	10,251	693	6.76
Total investment securities	**98,492**	**4,139**	**4.20**	104,476	4,235	4.05	92,299	4,326	4.69
Loans:									
Residential mortgage loans	**201,265**	**13,814**	**6.86**	192,596	13,363	6.94	181,602	13,199	7.27
Commercial & farm loans	**118,524**	**8,434**	**7.12**	98,064	6,678	6.81	77,584	5,777	7.45
Loans to state & political subdivisions	**38,766**	**2,308**	**5.95**	35,878	2,183	6.08	34,934	2,193	6.28
Other loans	**12,592**	**1,106**	**8.78**	12,298	1,100	8.94	12,656	1,151	9.09
Loans, net of discount (2)(3)(4)	**371,147**	**25,662**	**6.91**	338,836	23,324	6.88	306,776	22,320	7.28
Total interest-earning assets	**469,753**	**29,804**	**6.34**	444,298	27,569	6.21	402,062	26,675	6.63
Cash and due from banks	**8,764**			8,450			9,401		
Bank premises and equipment	**12,142**			11,169			10,967		
Other assets	**18,714**			18,495			15,405		
Total non-interest earning assets	**39,620**			38,114			35,773		
Total assets	**509,373**			482,412			437,835		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									
NOW accounts	**71,257**	**665**	**0.93**	63,210	268	0.42	55,195	212	0.38
Savings accounts	**39,939**	**113**	**0.28**	39,434	111	0.28	36,314	124	0.34
Money market accounts	**49,482**	**999**	**2.02**	44,607	481	1.08	47,065	493	1.05
Certificates of deposit	**213,109**	**7,596**	**3.56**	211,325	7,423	3.51	203,092	7,672	3.78
Total interest-bearing deposits	**373,787**	**9,373**	**2.51**	358,576	8,283	2.31	341,666	8,501	2.49

Other borrowed funds	**41,893**	**1,627**	**3.88**	35,117	952	2.71	14,286	325	2.27
Total interest-bearing liabilities	**415,680**	**11,000**	**2.65**	393,693	9,235	2.35	355,952	8,826	2.48
Demand deposits	**46,890**			44,763			41,266		
Other liabilities	**5,033**			4,637			3,707		
Total non-interest-bearing liabilities	**51,923**			49,400			44,973		
Stockholders' equity	**41,770**			39,319			36,910		
Total liabilities & stockholders' equity	**509,373**			482,412			437,835		
Net interest income		**18,804**			18,334			17,849	
Net interest spread (5)			**3.69%**			3.86%			4.16%
Net interest income as a percentage of average interest-earning assets			**4.00%**			4.13%			4.44%
Ratio of interest-earning assets to interest-bearing liabilities			**1.13**			1.13			1.13

(1) Averages are based on daily averages.
(2) Includes loan origination and commitment fees.
(3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%.
(4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.
(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Tax exempt interest 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. Accordingly, income tax adjustments of $354,000, $239,000 and $332,000 for investments and $751,000, $724,000 and $728,000 for loans have been made accordingly to the previous table for the years ended December 31, 2005, 2004 and 2003, respectively. The following table shows the tax-equivalent effect of changes in volume and rates on interest income and expense (in thousands):

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

	2005 vs. 2004 (1)			2004 vs. 2003 (1)		
	Change in Volume	**Change in Rate**	**Total Change**	Change in Volume	Change in Rate	Total Change
Interest Income:						
Short-term investments:						
Interest-bearing deposits at banks	**$ (14)**	**$ 7**	**$ (7)**	$ (20)	$ 1	$ (19)
Investment securities:						
Taxable	**(533)**	**(10)**	**(543)**	636	(490)	146
Tax-exempt	**482**	**(35)**	**447**	(223)	(14)	(237)
Total investments	**(65)**	**(38)**	**(103)**	393	(503)	(110)
Loans:						
Residential mortgage loans	**596**	**(145)**	**451**	778	(614)	164
Commercial & farm loans	**1,473**	**283**	**1,756**	1,427	(526)	901
Loans to state & political subdivisions	**173**	**(48)**	**125**	58	(68)	(10)
Other loans	**26**	**(20)**	**6**	(31)	(20)	(51)
Total loans, net of discount	**2,268**	**70**	**2,338**	2,232	(1,228)	1,004
Total Interest Income	**2,203**	**32**	**2,235**	2,625	(1,731)	894
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	**29**	**368**	**397**	41	15	56
Savings accounts	**2**	**-**	**2**	10	(23)	(13)
Money Market accounts	**45**	**473**	**518**	(27)	15	(12)
Certificates of deposit	**62**	**111**	**173**	303	(552)	(249)
Total interest-bearing deposits	**138**	**952**	**1,090**	327	(545)	(218)
Other borrowed funds	**120**	**555**	**675**	579	48	627
Total interest expense	**258**	**1,507**	**1,765**	906	(497)	409
Net interest income	**$ 1,945**	**$ (1,475)**	**$ 470**	$ 1,719	$ (1,234)	$ 485

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

2005 vs. 2004

As shown in the preceding tables, tax equivalent net interest income for 2005 was $18,804,000 compared with $18,334,000 for 2004, an increase of $470,000 or 2.6%. The increased volume of interest earning assets of $25.5 million generated an increase in interest income of $2,203,000. The average rate on interest earning assets increased from 6.21% in 2004 to 6.34% in 2005, which had the effect of increasing interest income by $32,000. The average balance of interest bearing liabilities increased $22.0 million, which had the effect of increasing total interest expense by $258,000. Furthermore, the average rate on interest bearing liabilities increased from 2.35% to 2.65%, which had the effect of increasing interest expense by $1,507,000 due to the flattened yield curve as discussed below.

Loan income increased $2,338,000 in 2005 from 2004. Our commitment and focus on growing good quality, commercial loans was the primary driver as income from these loans increased $1,756,000 over 2004. The average balance of commercial loans increased $20.5 million or 20.86%, while at the same time the average rate increased from 6.81% to 7.12%.

Residential mortgage loan income increased $451,000. The increase due to volume was $596,000, as the average balance increased $8.7 million. This was offset by a decrease in the average rate earned on these loans from 6.94% to 6.86%, which had the effect of decreasing interest income by $145,000.

Total tax equivalent interest income from investment securities decreased $103,000 in 2005 from 2004. Income from taxable investment securities decreased $543,000 due to a decrease in the average balance of $13.8 million. This was offset by an increase in tax-exempt investment income of $447,000. During 2005, the Company's strategy was to invest in bank qualified municipal securities with a maturity of up to 20 years in order to take advantage of higher tax-effected yields compared with other investment alternatives.

Interest expense on interest bearing deposits increased $1,090,000 in 2005 from 2004. The increase due to volume was $138,000 while the increase due to rate was $952,000. The increase in short term rates, reflective of the 200 basis point increase in the federal funds rate since the beginning of 2005, has resulted in an increase in the rates paid on NOW accounts, money market deposits and short-term certificates of deposit. Similarly, the increase in the average balance and rates paid on borrowings has increased interest expense by $675,000 in 2005.

The flattened yield curve, which has persisted for all of 2005, has resulted in a decrease in the net interest spread from 3.86% in 2004 to 3.69% in 2005. The yield curve has dampened the ability to increase the average rates on interest earning assets at the same pace as the increase in short-term deposit and borrowing rates. Many of the Company's interest earning assets re-price along the five year point of the curve, where interest rates have not significantly increased due to the flattened yield curve. The Company's liabilities, including borrowings and deposits, are shorter in nature and are more sensitive to short-term changes in interest rates. As the interest rate environment returns to a more normal yield curve, the Company's margin should improve. Should the flattened yield curve become more prevalent or remain in effect for an extended period, we will continue to see additional pressure on our margin.

2004 vs. 2003

Tax equivalent net interest income increased from $17,849,000 in 2003 to $18,334,000 in 2004, which is an increase of $485,000 or 2.7%. The increased volume of interest-earning assets generated an increase in interest income of $2,625,000 while increased volume of interest-bearing liabilities produced an additional $906,000 of interest expense. The change in volume resulted in a net increase of $1,719,000 in net interest income. The net change in rate was a negative $1,234,000 resulting in a total positive net change of $485,000 when combined with the change in volume.

Interest income on loans increased $1,004,000. The amount of increase related to loan volume was $2,232,000 while the decrease related to rate was $1,228,000. The average balance of loans increased $32.3 million, which is directly related to acquiring $27.3 million in loans from the Legacy branch acquisition.

Interest expense on interest bearing deposits decreased $218,000. The amount attributable to the change in average rate resulted in a decrease in interest expense of $545,000. This was offset by an increase due to volume of $327,000, largely attributable to deposits of $20.7 million assumed in the Legacy branch acquisition.

Interest expense on borrowed funds increased $627,000 compared with 2003. The increase due to volume totaled $579,000, while the increase due to rate was $48,000.

2004's net interest income compared to 2003 shows the effects of increasing short-term interest rates and the effect of a flattening of the yield curve. In 2004, the net interest spread decreased from 4.16% to 3.86%. During 2004, the Federal Reserve increased short-term interest rates by 125 basis points, in 25 basis point increments throughout the year, while long-term rates remained relatively unchanged. Particularly during the last six months of 2004, the yield curve became significantly flatter.

NON-INTEREST INCOME

The following table reflects non-interest income by major category for the periods ended December 31 (dollars in thousands):

		2005		2004		2003
Service charges	**$**	**2,965**	$	3,017	$	3,018
Trust		**474**		434		422
Brokerage		**183**		185		200
Insurance		**260**		175		209
Gains on loans sold		**70**		54		349
Investment securities (losses) gains, net		**-**		(235)		553
Earnings on bank owned life insurance		**294**		307		142
Other		**442**		355		419
Total	**$**	**4,688**	$	4,292	$	5,312

		2005/2004 Change			2004/2003 Change	
		Amount	%		Amount	%
Service charges	**$**	**(52)**	**(1.7)**	$	(1)	(0.0)
Trust		**40**	**9.2**		12	2.8
Brokerage		**(2)**	**(1.1)**		(15)	(7.5)
Insurance		**85**	**48.6**		(34)	(16.3)
Gains on loans sold		**16**	**29.6**		(295)	(84.5)
Investment securities (losses) gains, net		**235**	**(100.0)**		(788)	(142.5)
Earnings on bank owned life insurance		**(13)**	**(4.2)**		165	N/A
Other		**87**	**24.5**		(64)	(15.3)
Total	**$**	**396**	**9.2**	$	(1,020)	(19.2)

2005 vs. 2004

Overall, non-interest income increased $396,000 in 2005 from 2004, or 9.2%. Most of the increase is attributable to $235,000 of net investment securities losses recognized in 2004 compared to no gains or losses recognized in 2005.

Service charge income decreased $52,000 from the prior year level. Statement fees decreased $71,000, primarily due to the loss of a few large deposit customers with substantial account service fees. Fees charged to customers for non-sufficient funds also declined $80,000. Offsetting these decreases was an overall increase in ATM and check card related fee income. This increase is attributable primarily due to promotional efforts to increase retail customers' usage of debit cards for transactions.

Insurance revenue increased due to an increase in the volume of fixed and variable annuities compared to traditional mutual funds and brokerage products. Other income increased $87,000 due to an increase in mortgage servicing fees and credit insurance revenue from customers selecting loan protection from death and/or disability.

2004 vs. 2003

Non-interest income decreased $1,020,000 in 2004 compared with 2003, or 19.2%. Most of the decrease in 2004 is due to a decrease in investment securities gains of $788,000 compared to 2003. In 2004, the Company recorded an other than temporary impairment non-cash charge of $726,000 related to $3.8 million face value of perpetual preferred stock issued by Freddie Mac, a Government sponsored entity (see Footnote 3 of the consolidated financial statements for additional information). The perpetual preferred stock issues are investment grade securities that are held in the Company's available-for-sale securities portfolio. Prior to this 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 to stockholders' equity through other comprehensive income. Accordingly, the reclassification of the unrealized loss to an other-than-temporary impairment non-cash charge did not affect stockholders' equity. The decision to reclassify the unrealized marked-to-market loss on these securities to an other-than-temporary impairment charge was based on a very conservative interpretation of existing accounting guidance and literature and does not reflect on the expected long-term value of these investment grade securities. Additionally, in an effort to take advantage of existing market conditions in 2004, we elected to sell approximately $14,045,000 of investment securities, which resulted in $491,000 of security gains, excluding the impairment charge.

Gains on loans sold decreased $295,000 from 2003 primarily due to the slowdown in residential mortgage lending and refinancing activity in 2004 compared with 2003.

Offsetting these decreases was an increase in earnings on bank owned life insurance. The Company purchased $7,000,000 of bank owned life insurance during the third quarter of 2003. As the cash surrender value of the policies increase, earnings are recognized. The increase in the cash surrender value for 2003 for approximately five months was less than the increase for all twelve months of 2004 by $165,000.

NON-INTEREST EXPENSE

The following tables reflect the breakdown of non-interest expense and professional fees for the periods ended December 31 (dollars in thousands):

	2005	2004	2003
Salaries and employee benefits	**$ 7,645**	$ 7,636	$ 8,304
Occupancy	**1,142**	1,072	1,025
Furniture and equipment	**658**	695	713
Professional fees	**536**	630	694
Amortization of intangibles	**578**	506	435
Other	**4,828**	4,383	4,330
Total	**$ 15,387**	$ 14,922	$ 15,501

	2005/2004 Change		2004/2003 Change	
	Amount	%	Amount	%
Salaries and employee benefits	**$ 9**	**0.1**	$ (668)	(8.0)
Occupancy	**70**	**6.5**	47	4.6
Furniture and equipment	**(37)**	**(5.3)**	(18)	(2.5)
Professional fees	**(94)**	**(14.9)**	(64)	(9.2)
Amortization of intangibles	**72**	**14.2**	71	16.3
Other	**445**	**10.2**	53	1.2
Total				