

CITIZENS FINANCIAL SERVICES INC

Form ARS

March 08, 2005

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

2003

**BALANCE SHEET**

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

**STATEMENT OF INCOME**

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

**PER SHARE DATA**

Net Income		<b>1.85</b>		1.70
Cash Dividends		<b>0.78</b>		0.74

**TRUST DEPARTMENT**

Trust Assets Managed		<b>67,459</b>		70,384
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**TO OUR SHAREHOLDERS, CUSTOMERS AND FRIENDS,**

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

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

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

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

***A Season of Looking Ahead.....***

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

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

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

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

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

*....Toward the Horizon of a Bright Future*

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

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

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

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

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

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

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

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

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

Randall E. Black  
CEO & President

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

**1. EXCEEDING CUSTOMER EXPECTATIONS**

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

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

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

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

**3. DELIVER SUPERIOR SHAREHOLDER VALUE**

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

**4. EXHIBIT SOCIAL RESPONSIBILITY AND GOOD CITIZENSHIP**

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



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

*See accompanying notes to consolidated financial statements.*

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

<b>CASH DIVIDENDS PER SHARE</b>	<b>\$</b>	<b>0.78</b>	<b>\$</b>	<b>0.74</b>	<b>\$</b>	<b>0.67</b>
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*See accompanying notes to consolidated financial statements.*

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

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

Investment losses (gains) included in net  
income, net

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

10

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

**Supplemental Disclosures of Cash Flow****Information:**

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

*See accompanying notes to consolidated financial statements.*

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### BUSINESS AND ORGANIZATION

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

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

### BASIS OF PRESENTATION

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

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

### OPERATING SEGMENTS

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

### INVESTMENT SECURITIES

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

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

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

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



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

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

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

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

#### LOANS

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