

CITIZENS FINANCIAL SERVICES INC

Form ARS

March 14, 2006

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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 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 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.

<i>(in thousands, except share data)</i>	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>ASSETS:</b>		
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
<b>TOTAL ASSETS</b>	<b>\$ 529,241</b>	<b>\$ 499,347</b>
<b>LIABILITIES:</b>		
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
<b>TOTAL LIABILITIES</b>	<b>487,680</b>	<b>458,558</b>
<b>STOCKHOLDERS' EQUITY:</b>		
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
<b>TOTAL</b>	<b>45,575</b>	<b>42,636</b>
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)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>41,561</b>	<b>40,789</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 529,241</b>	<b>\$ 499,347</b>
<i>See accompanying notes to consolidated financial statements.</i>		

**Year Ended December 31,**

*(in thousands, except per share data)*