CITIZENS FINANCIAL SERVICES INC
Form ARS
March 13, 2007

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As I sit down to write this year's annual letter, I look back at 2006 as a year of major accomplishments and milestones for our Company, Citizens Financial Services, Inc.

It is with great pleasure to report that 2006 was a year of record financial achievement, as consolidated net income reached a record level of $5,800,000, compared to $5,274,000 in 2005, representing an increase of 10.0%. We are extremely proud of this performance, especially since the banking industry continues to be challenged by an ongoing difficult interest rate environment and increased competitive pressures.

Our 2006 performance resulted in earnings per share of $2.04, which represents an increase of 11.5% over 2005 earnings per share of $1.83. This level of performance resulted in a return on average assets of 1.05% and return on average equity of 13.21%, which compares to a return on average assets of 1.04% and return on average equity of 12.63% for 2005. Excluding the first year costs associated with our new Wellsville Office, earnings per share would have been $2.09.

Our record earnings growth was driven by a combination of expense reduction and proactive tax planning strategies to offset overall declining margins, while continuing to grow the bank through our total customer relationship approach as evidenced by an 8.4% growth in loans and a 3.9% growth in deposits during the year.

The Company's balance sheet continued to expand during 2006 with assets ending the year at a record level of $572,168,000. This represents a $42,927,000 or 8.1% increase over 2005. In addition to our loan growth, we took advantage of some market opportunities within our investment portfolio during the course of the year to improve our overall portfolio mix. Because the difficult interest rate environment and increased competition limited deposit growth, we elected to support the addition of assets with borrowed funds. More specifically, we were able to stay true to our sound pricing strategies and manage the impact to our net interest margin by funding our asset growth with short-term borrowings.

Asset quality remains at a very high level and continues to strengthen. During 2006, we experienced net charge-offs of $118,000 representing .03% of average loans. This compares favorably to our peer group. At year end, our classified asset ratio was 17.6% compared to 20.1% in 2005. This also compares favorably to the industry benchmark of 25.0%.

Stockholders' equity increased $1,939,000 to $43,500,000 at December 31, 2006, as earnings outpaced dividends paid and common stock repurchased. Cash dividends of $.86 per share represented an increase of 4.9% over 2005. On January 17, 2006, the Board of Directors approved a plan to repurchase up to 140,000 shares of its common stock. I'm pleased to report that by year-end 54,239 shares of treasury stock have been repurchased in open market or privately negotiated transactions.

Our record accomplishments continued as our Investment and Trust Services Division was able to grow assets under management by 9.8% in 2006 to over $82 million. We continue to strengthen our focus on retirement planning and have recently hired a specialist in this area. The knowledge and experience of our Trust employees and financial consultants gives us the in-house expertise to provide individualized financial solutions to our customers. More information about our Investment and Trust Services Division can be found on pages 6 and 7 of this annual report.

Our attention and energies in 2006 were largely devoted to our Wellsville, New York, branch. In October, we completed construction of our 3,600 square foot permanent facility, less than 12 months after opening the doors to our temporary facility in December 2005. The residents and businesses of the community have welcomed us and have responded positively to our customer relationship approach. Every customer is treated with respect, and we take great pleasure in making their lives more rewarding by meeting their financial needs. This customer relationship approach has resulted in 400 new customers joining the First Citizens family. In addition, our new office has made banking more convenient for the over 800 customers who were already doing business with us.

Everyday I realize how truly blessed I am to be part of this organization and to be working side-by-side with the main reason for our success - our employees. They consistently make quality service a priority and demonstrate, on a daily basis, why First Citizens National Bank is the preferred choice for our customers. In 2006, the number of scams and cases of information theft in the United States and abroad increased to an all time high. First Citizens National Bank handled over 200 fraud cases in 2006 as compared to12 cases just five years ago. Our employees have risen to the challenge of protecting our customers, which is no easy task as the number and variety of scams continues to increase each day. Their awareness and diligence has resulted in minimal losses to both the bank and customers, and as a result, in September, we recognized 61 community office employees for their efforts.

So much of what we do is inspired by a desire to see our communities thrive. In 2006, First Citizens National Bank invested over $54 million in loans to small businesses and municipalities helping to keep jobs local and business communities healthy. We continue to use local vendors and customers to fulfill our product and service needs. Our partnership with the agricultural community grows stronger each day keeping farming alive and well in our markets. As the Number One Mortgage Lender in the Northern Tier, we provided funding to over 1,500 customers to buy or build a new home, or improve the one they already have. Our contributions to libraries, parks, education, health care and culture all play a major role in building better communities. In addition to supporting our communities through economic activity, First Citizens National Bank continues to emphasize community development through the civic involvement of our employees. Their leadership and participation is very important to many civic and charitable organizations that are critical to the overall quality of life in the communities in which we live and operate. Our employees donate thousands of hours each year to schools, youth programs, religious organizations, economic development efforts and other worthy causes.

It is likely that the yield curve will remain inverted or flat in 2007 and consumers will continue to be price-conscious. This will present us with another challenging year. In response, we will remain diligent to the pricing and growth initiatives outlined in our strategic plan, which involves evaluating the economic and competitive markets, as well as thoroughly understanding our customer needs. Opportunities impacting non-interest income and cost control will continue to be evaluated. Meeting the needs of small businesses and understanding the ever-changing issues facing the agricultural industry will remain priorities.

In April, Larry J. Croft retired from our board of directors. Larry joined the Citizens Financial Services, Inc. and First Citizens National Bank boards in 1990 when we acquired Star Savings & Loan where he had served as a director since 1969. His dedication to our customers, employees and shareholders truly made a difference. We sincerely appreciate Larry's years of service, advice and dedication and wish him many happy and healthy years of retirement. At the same time, Robert W. Chappell of our LeRaysville local board and Rinaldo A. DePaola of our Towanda local board were voted in as a Class 3 and Class 1 director respectively at our 2006 Annual Meeting. I invite you to learn more about Larry, Bob and Ray on page 8 of this annual report.

I greatly appreciate the hard work of our board of directors, officers and employees throughout 2006. I also extend my appreciation to you, our shareholders, for your ongoing trust and support of Citizens Financial Services, Inc., including many referrals of new business to First Citizens National Bank.

On June 11, 2007, we will celebrate our 75th year as First Citizens National Bank, a milestone we're very proud of as we are not only celebrating longevity, but financial strength, independence and performance. We will communicate our plans once they are final and hope you can help us celebrate this special event. We look forward to another year of strong financial performance, excitement and rewards.

Randall E. Black
Chief Executive Officer and President

Our ability to achieve our customers' investment objectives while providing superior customer service has allowed us to grow assets under management to over $82.6 million in 2006, a 9.8% increase from year-end 2005. Our team has grown as well. We added a second Business Development Officer and a Trust Administrator dedicated to the management of trust assets. The group now has over 90 combined years of trust experience and an equally impressive amount of education and training.

Kristen D'Angelo, Trust and Investment Administrator, joined First Citizens in 2005 to add expertise for the management of trust assets. Prior to joining First Citizens, Kristen was the Investment Assistant for the Trust Division of a local community bank. She has earned a Bachelor of Science degree in Accounting from Susquehanna University and is also a graduate of the American Bankers Association National Trust School and the Cannon Financial Institute of Trust Investments.

Jean Knapp, AVP and Trust Officer, has devoted 26 continuous years of service to the Trust Department. Her responsibilities include personal trust administration and a focus on estate settlement. Jean is a graduate of the Central Atlantic School of Trust and the H&R Block Tax Preparation School.

Linda Kriner, VP and Trust Officer, joined First Citizens in 2005, bringing 30 years of trust and estate experience. Prior to joining First Citizens, Linda's job responsibilities included personal trust administration, estate settlement, and business development. She is a graduate of the Central Atlantic School of Trust, the Cannon Financial Institute's Personal Trust School, and the American Bankers Association Graduate Trust School. Linda summed up her feelings about the Department by saying, ***"As Business Development Officer, I'm frequently out of the office and find great comfort in knowing that my clients are in the hands of such experienced and caring people."***

Sara Roupp, AVP and Trust Officer, has devoted over 19 years to our Investment and Trust Services Division. Sara is responsible for business development in Mansfield and the Bradford County area. She also acts as a personal trust administrator and manages the Department's retirement plans. Sara has graduated from the Central Atlantic School of Trust and the American Bankers Association National Trust School, and she currently is studying Business Administration at Mansfield University. When asked about the most satisfying part of her position, Sara commented, ***"I'm in the business of providing peace of mind."***

Sylvia Thompson, Trust Administrator, has worked in our Trust Department for almost eight years. Sylvia is responsible for the operational management of the Department. She has earned a Bachelors Degree in Business Administration from Mansfield University and has graduated from the Central Atlantic School of Trust.

First Citizens continues to strengthen our Investment and Trust Services Division in support of our commitment to meeting all the financial needs of our customers. We recently formed a partnership with UVEST Financial Services that will allow us to be more proactive in managing each customer relationship and will expand the range of investment products and services we offer. Our Financial Consultants will help each customer to determine his or her financial objectives and will provide an investment strategy specifically tailored to achieve those objectives.

Matt Geer, UVEST Financial Consultant, works with our customers in the Wellsboro, Mansfield, Blossburg, Troy, and Canton markets. Matt graduated from the United States Coast Guard Academy with a Bachelors Degree in Business Management.
He holds Series 7 and 63 licenses and has attended the New York Bankers Association Trust and Investment Management School. Prior to joining First Citizens, Matt was an Assistant Portfolio Manager and Securities Trader for Chemung Canal Trust Company and was employed as a Financial Advisor for Morgan Stanley. Matt defines a good day as ***"one where I have helped a customer achieve a higher level, whether a financial success or an understanding and confidence in the plan we developed for their future."***

Jeff Dugan, UVEST Financial Consultant, was a partner of Dugan Tractor, Inc. and manager of Maple Mountain Equipment before joining the Investment and Trust Services Division.
He received a Bachelors Degree in Business Administration from Mansfield University and holds Series 7 and 63 licenses. Jeff served on the Ulysses local board for over 5 years, and his dedication to First Citizens will continue as he supports the Ulysses, Genesee, and Wellsville markets.

Sarah Bresee, UVEST Financial Consultant, serves our Sayre, Towanda, LeRaysville, Gillett, and Millerton offices. Sarah is a Certified Financial Planner and studied financial planning at Boston University.
She holds her Series 7 and 63 licenses. Sarah has worked as a Retirement Planning Specialist at Chemung Canal Trust Company and as a Financial Advisor with AIG VALIC in Binghamton, New York.

Larry J. Croft

Larry Croft joined our Corporate Board of Directors in 1990 when we acquired Star Savings and Loan where he had been a director since 1969.

He has served on many committees of the board. Most recently his expertise had been utilized as chairman of the Credit Committee, member of our Compensation/Human Resource Committee and the Governance and Nominating Committee. Larry has performed his duties and responsibilities as a director with excellence. His years of service are marked by exemplary dedication to the customers, employees and shareholders of this Company.

Larry is currently the owner of Croft Ford Incorporated in Athens, Pennsylvania. He has been associated with this organization for over 40 years. Prior to entering the automobile sales industry, Larry worked for Croft Lumber Company in Sayre, Pennsylvania.

Larry currently resides with his wife Ellen in Litchfield, Pennsylvania. He dedicates his free time to family and his special interests of showing quarter horses and traveling.

Both Bob Chappell and Ray DePaola joined our corporate board in April of 2006. As members of our local Advisory Boards, they understand our customer relationship approach and our commitment to small business, the agricultural industry and community involvement and development. As local board members, they ensure First Citizens has a clear understanding of the needs and goals of the businesses and residents of the communities they represent. As Corporate Board members, Bob and Ray have continued to be the voice of their communities as well as perform duties and responsibilities that provide guidance and direction for our Company.

Robert W. Chappell

Bob is a partner in the law firm of van der Hiel, Chappell & Loomis, doing business in Rome and Mansfield, Pennsylvania. He is a graduate of Widener University School of Law and Mansfield University. Bob served in the United States Marine Corps and

Rinaldo A. DePaola

Ray has been practicing law for 25 years and is currently a partner with the law firm of Griffin, Dawsey, DePaola and Jones, P.C. in Towanda, Pennsylvania. He is a graduate of the Temple Law School and the University of Scranton.

received several commendations for outstanding achievement.

Bob is a member of our LeRaysville local board and is actively involved in organizations such as Betterment Organization of Mansfield (BOOM) and the Northeast Bradford School District.

Bob was born and raised in Rome. He continues to reside there today where he enjoys the outdoors in his free time.

Ray is a member of our Towanda local board. He is actively involved in both civic and professional organizations in the Towanda area including Trustee of Memorial Hospital, the Lions Club and a member of the Board of Directors of Northern Tier Counseling.

Ray is an avid baseball fan, with a passion for the Philadelphia Phillies, traveling to Clearwater Florida each year for spring training. Ray resides in Towanda with his wife, Geri Ann and two children, Frances and Ray.

- 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.

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.

- 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.

- 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.

A key attribute of our vision is to exhibit social responsibility and good citizenship by proactively contributing knowledge, skills, time and money to organizations that impact our economy and social vitality.

We support and encourage employee involvement in schools, community groups, professional associations and charities. It is our goal to be a leader and role model for other organizations.

Consumers make better choices when they are well informed. For this reason, First Citizens is committed to making information easily available on subjects that are pertinent to the financial welfare of our customers. At the end of the day, we want our customers to feel good about the decisions they've made.

• Financial Education is incredibly important to our children's futures. For this reason, our employees visit elementary and high schools each year to teach kids about the importance of saving money and to ensure high school students understand the importance of building and maintaining good credit.

• Each year, we deliver or sponsor programs focused on financial subjects related to Retirement Planning, Estate Planning and Small Business issues. In November, we sponsored a seminar for local farmers on Succession Planning and Business Planning and Expansion.

• On a routine basis, we submit articles of interest to our local newspapers on topics such as tips on avoiding financial scams and identity theft, the value of good credit, first-time home buying and understanding investment products.

• In 2006, we introduced two scholarships to Mansfield University. One scholarship is awarded to a member of the community and one to a First Citizens employee, director or family member. The scholarship requirements focus on academic excellence as well as community involvement.

• We continue to sponsor the First Citizens Scholarship Challenge - This academic competition provides high school students throughout the Twin Tiers with the opportunity to showcase their knowledge and receive monetary awards for their schools.

• Our website, ***www.firstcitizensbank.com***, provides many tools for consumer education. Mortgage 101 helps consumers understand the entire home buying process, from determining how much of a home they can afford and the various mortgage programs available, to understanding what happens at the closing. Our Home Improvement Calculator helps consumers estimate the cost of different home projects as well as the amount of their monthly Home Equity Loan Payment. And our Retirement Planning Calculator provides consumers with a tool to determine if their retirement strategy makes sense, no matter what stage of life they may be in.

In order to make a real difference, our monetary donations have been targeted toward children and youth, community development, cultural activities and supporting the many health service organizations that serve our communities.

• In 2006, we made significant financial commitments towards the restoration of the Mansfield and Wellsville Libraries. These centers for learning are an important part of our past and fundamental to our future. We've committed funds to revitalize town parks and movie theatres, and we're proud to have little league teams across the northern tier wear our name on their uniforms.

• Our employees dedicate thousands of hours each year to a variety of civic organizations and charities. From baseball coaches, scout leaders and 4-H leaders to school board members and community development organizations, everywhere you look, you see leadership and participation from our employees and directors.

• Raising money for the American Cancer Society has been a core focus for First Citizens and our employees. Our never-ending efforts have raised over $100,000 for this very worthy cause. To accomplish this, our employees have organized and participated in continuous fundraisers such as auctions and food sales, plus they spend countless hours every year organizing the First Citizens Cancer Classic golf tournament and participating in the Relay for Life Walk-a-Thon.

(in thousands, except share data)	December 31, **2006**		2005	
ASSETS:				
Cash and cash equivalents:				
Noninterest-bearing	**$**	**10,007**	$	8,498
Interest-bearing		**8**		111
Total cash and cash equivalents		**10,015**		8,609
Available-for-sale securities		**109,743**		102,602
Loans (net of allowance for loan losses:				
2006, $3,876; 2005, $3,664)		**410,897**		379,139
Premises and equipment		**12,892**		12,305
Accrued interest receivable		**2,458**		2,164
Goodwill		**8,605**		8,605
Bank owned life insurance		**8,047**		7,743
Other assets		**9,511**		8,074
TOTAL ASSETS	**$**	**572,168**	$	529,241
LIABILITIES:				
Deposits:				
Noninterest-bearing	**$**	**48,509**	$	50,600
Interest-bearing		**398,006**		379,199
Total deposits		**446,515**		429,799
Borrowed funds		**75,775**		52,674
Accrued interest payable		**2,287**		1,862
Commitment to purchase investment securities		**-**		752
Other liabilities		**4,091**		2,593
TOTAL LIABILITIES		**528,668**		487,680
STOCKHOLDERS' EQUITY:				
Common Stock				
$1.00 par value; authorized 10,000,000 shares;				
issued 2,992,896 and 2,965,257 shares				
in 2006 and 2005, respectively		**2,993**		2,965
Additional paid-in capital		**11,933**		11,359
Retained earnings		**34,007**		31,251
Accumulated other comprehensive loss		**(1,737)**		(1,540)
Treasury stock, at cost:				
172,954 and 118,715 shares for 2006 and 2005, respectively		**(3,696)**		(2,474)
TOTAL STOCKHOLDERS' EQUITY		**43,500**		41,561
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**$**	**572,168**	$	529,241

See accompanying notes to consolidated financial statements.

(in thousands, except per share data)	**2006**	2005	2004
	Year Ended December 31,		
INTEREST AND DIVIDEND INCOME:			
Interest and fees on loans	**$ 28,101**	$ 24,911	$ 22,600
Interest-bearing deposits with banks	**-**	3	10
Investment securities:			
Taxable	**3,526**	2,979	3,413
Nontaxable	**903**	596	301
Dividends	**321**	210	282
TOTAL INTEREST AND DIVIDEND INCOME	**32,851**	28,699	26,606
INTEREST EXPENSE:			
Deposits	**11,685**	9,373	8,283
Borrowed funds	**3,268**	1,627	952
TOTAL INTEREST EXPENSE	**14,953**	11,000	9,235
NET INTEREST INCOME	**17,898**	17,699	17,371
Provision for loan losses	**330**	60	-
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**17,568**	17,639	17,371
NON-INTEREST INCOME:			
Service charges	**3,140**	2,965	3,017
Trust	**487**	474	434
Brokerage	**166**	183	185
Insurance	**94**	260	175
Investment securities gains (losses), net	**4**	-	(235)
Earnings on bank owned life insurance	**304**	294	307
Other	**521**	512	409
TOTAL NON-INTEREST INCOME	**4,716**	4,688	4,292
NON-INTEREST EXPENSES:			
Salaries and employee benefits	**8,026**	7,645	7,636
Occupancy	**1,123**	1,142	1,072
Furniture and equipment	**593**	658	695
Professional fees	**551**	536	630
Amortization of intangibles	**252**	578	506
Other	**4,482**	4,828	4,383
TOTAL NON-INTEREST EXPENSES	**15,027**	15,387	14,922
Income before provision for income taxes	**7,257**	6,940	6,741
Provision for income taxes	**1,457**	1,666	1,474
NET INCOME	**$ 5,800**	$ 5,274	$ 5,267
NET INCOME - EARNINGS PER SHARE	**$ 2.04**	$ 1.83	$ 1.82
CASH DIVIDENDS PER SHARE	**$ 0.86**	$ 0.82	$ 0.76

See accompanying notes to consolidated financial statements.

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(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, 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, $.76 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
Comprehensive income:							
Net income				**5,800**			**5,800**
Cumulative effect of change in accounting for pension obligation, net of tax benefit of $439					**(852)**		**(852)**
Change in net unrealized loss on securities available-for-sale, net of tax expense of $339					**655**		**655**
Total comprehensive income							**5,603**
Stock dividend	**27,639**	**28**	**574**	**(602)**			
Purchase of treasury stock (54,239 shares)						**(1,222)**	**(1,222)**
Cash dividends, $.86 per share				**(2,442)**			**(2,442)**

Balance, December 31, 2006	**2,992,896**	**$ 2,993**	**$ 11,933**	**$ 34,007**	**$ (1,737)**	**$ (3,696)**	**$ 43,500**

	2006	2005	2004
Components of comprehensive loss:			
Change in net unrealized gain (loss) on investment			
securities available-for-sale	**$ 658**	$ (1,470)	$ (947)
Change in unrecognized pension costs	**(852)**	(234)	-
Investment losses (gains) included in net income, net			
of tax (benefit) expense of $1, $0, and $(80)	**(3)**	-	155
Total	**$ (197)**	$ (1,704)	$ (792)

See accompanying notes to consolidated financial statements.

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(in thousands)	Year Ended December 31, **2006**	2005	2004
Cash Flows from Operating Activities:			
Net income	$ **5,800**	$ 5,274	$ 5,267
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	**330**	60	-
Depreciation and amortization	**899**	1,327	1,444
Amortization and accretion on investment securities	**369**	712	912
Deferred income taxes	**109**	256	(166)
Investment securities (gains) losses, net	**(4)**	-	235
Earnings on bank owned life insurance	**(304)**	(294)	(307)
Realized gains on loans sold	**(61)**	(70)	(54)
Originations of loans held for sale	**(3,317)**	(5,433)	(3,048)
Proceeds from sales of loans held for sale	**3,384**	5,503	3,102
Increase in accrued interest receivable	**(294)**	(429)	(33)
Increase (decrease) in accrued interest payable	**425**	(8)	(18)
Other, net	**(321)**	917	(167)
Net cash provided by operating activities	**7,015**	7,815	7,167
Cash Flows from Investing Activities:			
Available-for-sale securities:			
Proceeds from sales of available-for-sale securities	**10,439**	-	14,045
Proceeds from maturity and principal repayments of securities	**18,697**	17,571	24,571
Purchase of securities	**(36,401)**	(27,366)	(30,122)
Proceeds from redemption of Regulatory Stock	**2,576**	2,702	1,585
Purchase of Regulatory Stock	**(3,723)**	(2,783)	(1,814)
Net increase in loans	**(32,420)**	(23,676)	(15,405)
Purchase of loans	**-**	-	(27,340)
Purchase of premises and equipment	**(1,335)**	(1,306)	(2,319)
Proceeds from sale of premises and equipment	**-**	200	34
Deposit acquisition premium	**-**	-	(2,200)
Proceeds from sale of foreclosed assets held for sale	**405**	486	338
Net cash used in investing activities	**(41,762)**	(34,172)	(38,627)
Cash Flows from Financing Activities:			
Net increase in deposits	**16,716**	10,300	12,720
Proceeds from long-term borrowings	**8,492**	8,594	654
Repayments of long-term borrowings	**(8,787)**	(3,471)	(1,519)
Net increase in short-term borrowed funds	**23,396**	12,577	545
Dividends paid	**(2,442)**	(2,335)	(2,209)
Deposits of acquired branches	**-**	425	20,663
Purchase of treasury stock	**(1,222)**	(463)	(6)
Net cash provided by financing activities	**36,153**	25,627	30,848
Net Increase (decrease) in cash and cash equivalents	**1,406**	(730)	(612)
Cash and Cash Equivalents at Beginning of Year	**8,609**	9,339	9,951

Cash and Cash Equivalents at End of Year	**$**	**10,015**	$	8,609	$	9,339
Supplemental Disclosures of Cash Flow Information:						
Interest paid	**$**	**14,528**	$	10,973	$	9,253
Income taxes paid	**$**	**1,645**	$	1,150	$	1,780
Noncash activities:						
Real estate acquired in settlement of loans	**$**	**463**	$	369	$	718

See accompanying notes to consolidated financial statements.

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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 brokerage division that provides 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, 2006 and 2005.

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, 2006 and 2005.

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 non-accrual 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 "non-accrual loans," although the two categories overlap. The Company may choose to place a loan on non-accrual 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 1⁄2 year life on a straight-line basis. The recoverability of the carrying value of intangible assets is evaluated on an ongoing basis, and permanent declines in value, if any, are charged to expense.

Goodwill

The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards ("FAS") No. 142, "Goodwill and Other Intangible Assets". This statement, among other things, requires a two-step process for testing the impairment of goodwill on at least an annual basis. This approach could cause more volatility in the Company's reported net income because impairment losses, if any, could occur irregularly and in varying amounts. The Company performs an annual impairment analysis of goodwill. Based on the fair value of the reporting unit, estimated using the expected present value of future cash flows, no impairment of goodwill was recognized in 2006 or 2005.

Bank Owned Life Insurance

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

Income Taxes

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

Employee Benefit Plans

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

The Company 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.

In 2006, the shareholders of the Company approved a restricted stock plan which covers eligible employees and non-employee corporate directors. Under the plan, awards are granted based upon performance related requirements and are subject to certain vesting criteria.

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 February 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 155, "Accounting for Certain Hybrid Instruments," as an amendment of FASB Statements No. 133 and 140. FAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In March 2006, the FASB issued FAS No. 156, "Accounting for Servicing of Financial Assets." This statement, which is an amendment to FAS No. 140, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FAS No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. FAS No. 156 also clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability; requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; and permits an entity with a separately recognized servicing asset or servicing liability to choose either of the amortization or fair value methods for subsequent measurement. The provisions of FAS No. 156 are effective as of the beginning of the first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In September 2006, the FASB issued FAS No. 157, "Fair Value Measurements," which provides enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. 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 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." FIN 48 is an interpretation of FAS No. 109, Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. This Interpretation clarifies that management is expected to evaluate an income tax position taken or expected to be taken for likelihood of realization before recording any amounts for such position in the financial statement. FIN 48 also requires expanded disclosure with respect to income tax positions taken that are not certain to be realized. This Interpretation is effective for fiscal years beginning after December 15, 2006, and will require management to evaluate every open tax position that exists in every jurisdiction on the date of initial adoption. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations and financial condition.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-4 ("EITF 06-4"), "Accounting for Deferred Compensation and Post-retirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." The guidance is applicable to endorsement split-dollar life insurance arrangements, whereby the employer owns and controls the insurance policy, that are associated with a post-retirement benefit. EITF 06-4 requires that for a split-dollar life insurance arrangement within the scope of the issue, an employer should recognize a liability for future benefits in accordance with FAS No. 106 (if, in substance, a post-retirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-5("EITF 06-5"), "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance." EITF 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations and financial condition.

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

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

Trust Assets and Income
Assets held by the 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 2,844,125, 2,884,232, and 2,895,770 for 2006, 2005 and 2004, 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 $844,000 and $814,000 at December 31, 2006 and 2005, respectively.
Non-retirement account 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, 2006 and 2005 were as follows (in thousands):

December 31, 2006	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Available-for-sale securities:				
U.S. Agency securities	**$ 16,647**	**$ 96**	**$ (92)**	**$ 16,651**
Obligations of state and political subdivisions	**22,591**	**92**	**(121)**	**22,562**
Corporate obligations	**7,981**	**21**	**(5)**	**7,997**
Mortgage-backed securities	**60,950**	**90**	**(1,165)**	**59,875**
Equity securities	**2,560**	**98**	**-**	**2,658**
Total available-for-sale	**$ 110,729**	**$ 397**	**$ (1,383)**	**$ 109,743**

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

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, 2006 and 2005 (in thousands). As of December 31, 2006 and 2005, the Company owned 75 and 79 securities whose market value was less than their cost basis, respectively.

December 31, 2006	**Less than Twelve Months**		**Twelve Months or Greater**		**Total**	
	Estimated Fair Value	**Gross Unrealized Losses**	**Estimated Fair Value**	**Gross Unrealized Losses**	**Estimated Fair Value**	**Gross Unrealized Losses**
U.S. Government agencies and corporations	**$ -**	**$ -**	**$ 8,214**	**$ 92**	**$ 8,214**	**$ 92**
Obligations of states and political subdivisions	**8,061**	**57**	**6,637**	**64**	**14,698**	**121**
Corporate obligations	**4,930**	**5**	**-**	**-**	**4,930**	**5**
Mortgage-backed securities	**7,466**	**36**	**39,996**	**1,129**	**47,462**	**1,165**
Total securities	**$ 20,457**	**$ 98**	**$ 54,847**	**$ 1,285**	**$ 75,304**	**$ 1,383**

December 31, 2005	Less than Twelve Months		Twelve Months or Greater		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair 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

The Company's investment securities portfolio contains unrealized losses on 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 2006, 2005, and 2004 were $10,439,000, $0, and $14,045,000, respectively. Gross gains and gross losses were realized on those sales as follows (in thousands):

	2006	2005	2004
Gross gains	**$ 159**	$ -	$ 517
Gross losses	**155**	-	26
Net gains	**$ 4**	$ -	$ 491

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 $81,894,000 and $83,748,000 at December 31, 2006 and 2005, 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, 2006, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Estimated Fair Value
Available-for-sale securities:		
Due in one year or less	$ 696	$ 692
Due after one year through five years	36,945	36,315
Due after five years through ten years	24,988	24,743
Due after ten years	45,540	45,335
Total	$ 108,169	$ 107,085

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, 2006 and 2005, 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, 2006	December 31, 2005
Real estate loans:		
Residential	$ 206,059	$ 195,628
Commercial	94,122	82,128
Agricultural	17,054	12,991
Construction	7,027	7,245
Loans to individuals for household, family and other purchases	12,482	13,017
Commercial and other loans	32,766	29,260
State and political subdivision loans	45,263	42,534
	414,773	382,803
Less allowance for loan losses	3,876	3,664
Loans, net	$ 410,897	$ 379,139

Real estate loans serviced for Freddie Mac and Fannie Mae, which are not included in the consolidated balance sheet, totaled $36,226,000 and $36,306,000 at December 31, 2006 and 2005, respectively.

At December 31, 2006 and 2005, net unamortized loan fees and costs of $996,000 and $890,000, respectively, have been deducted from the carrying value of loans.

The Company had non-accrual loans, inclusive of impaired loans, of $1,668,000 and $1,898,000 at December 31, 2006 and 2005, respectively. Interest income on loans would have increased by approximately $169,000, $144,000 and $87,000 during 2006, 2005 and 2004, 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):

	2006	2005	2004
Impaired loans without related allowance for loan losses	**$ 469**	$ 673	$ 229
Impaired loans with related allowance for loan losses	**721**	358	832
Related allowance for loan losses	**232**	179	6
Average recorded balance of impaired loans	**1,283**	1,148	1,091
Interest income recognized on impaired loans	**6**	7	18

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

	Year Ended December 31,		
	2006	2005	2004
Balance, beginning of year	**$ 3,664**	$ 3,919	$ 3,620
Provision charged to income	**330**	60	-
Increase related to acquisition	**-**	-	290
Recoveries on loans previously charged against the allowance	**172**	57	324
	4,166	4,036	4,234
Loans charged against the allowance	**(290)**	(372)	(315)
Balance, end of year	**$ 3,876**	$ 3,664	$ 3,919

The following is a summary of the past due and non-accrual loans as of December 31, 2006 and 2005 (in thousands):

	December 31, 2006		
	Past Due 30 - 89 days	**Past Due 90 days or more**	**Nonaccrual**
Real estate loans	**$ 3,230**	**$ 1,655**	**$ 1,578**
Installment loans	**258**	**5**	**10**
Commercial and all other loans	**233**	**30**	**80**
Total	**$ 3,721**	**$ 1,690**	**$ 1,668**

	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	-
Commercial and all other loans	325	32	164
Total	$ 2,521	$ 337	$ 1,898

5. PREMISES & EQUIPMENT

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

	December 31,			
		2006		2005
Land	**$**	**2,998**	$	2,954
Buildings		**11,634**		10,606
Furniture, fixtures and equipment		**7,081**		6,815
Construction in process		**798**		841
		22,511		21,216
Less: accumulated depreciation		**9,619**		8,911
Premises and equipment, net	**$**	**12,892**	$	12,305

Depreciation expense amounted to $747,000, $798,000 and $833,000 for 2006, 2005, and 2004, respectively.

6. GOODWILL

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

	December 31,			
		2006		2005
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 2006, 2005 or 2004.

7. CORE DEPOSIT INTANGIBLE ASSETS

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

	December 31,			
		2006		2005
Gross carrying amount	**$**	**3,553**	$	3,553
Less: accumulated amortization		**3,121**		2,869
Net carrying amount	**$**	**432**	$	684

Amortization expense amounted to $252,000, $578,000 and $506,000 for 2006, 2005 and 2004, respectively. The estimated amortization expense of intangible assets for each of the three succeeding fiscal years is as follows *(*in thousands*)*:

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	$	432

8. DEPOSITS

Certificates of deposit of $100,000 or more amounted to $67,912,000 and $55,894,000 at December 31, 2006 and 2005, respectively. Interest expense on certificates of deposit of $100,000 or more amounted to $2,667,000, $2,036,000 and $1,843,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

Following are maturities of certificates of deposit as of December 31, 2006 (in thousands):

2007	$ 119,963
2008	51,671
2009	22,815
2010	20,903
2011	11,912
Thereafter	972
Total certificates of deposit	$ 228,236

9. BORROWED FUNDS

(dollars in thousands)	Securities Sold Under Agreements to Repurchase(a)	Treasury Direct Investments(b)	FHLB Advances(c)	Federal Funds Line (d)	Notes Payable(e)	Term Loans(f)	Total Borrowed Funds
2006							
Balance at December 31	**$ 6,638**	**$ -**	**$ 45,637**	**$ -**	**$ 7,500**	**$ 16,000**	**$ 75,775**
Highest balance at any month-end	**9,531**	**2,470**	**45,637**	**5,000**	**7,500**	**19,000**	**89,138**
Average balance	**8,388**	**319**	**30,719**	**685**	**7,500**	**16,024**	**63,635**
Weighted average interest rate:							
Paid during the year	**4.69%**	**4.68%**	**5.21%**	**4.98%**	**8.00%**	**3.79%**	**5.10%**
As of year-end	**4.83%**	**0.00%**	**5.41%**	**0.00%**	**8.16%**	**4.46%**	**5.42%**
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%

(a) Securities sold under agreements to repurchase mature within 5 years. The carrying value of the underlying securities at December 31, 2006 and 2005 was $10,943,000 and $11,389,000, respectively.

(b) Treasury Direct Investments 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 $226,934,000, 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, 2006 and 2005, the approximate carrying value of the securities collateral was $76,526,000 and $56,985,000, 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, 2006 and 2005, the rate was 8.16% and 7.30%, 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, 2006**	December 31, 2005
Variable:			
(g)	June 30, 2007	**$ -**	$ -
Fixed:			
2.45%	June 19, 2006	**-**	4,000
2.76%	December 18, 2006	**-**	3,000
3.69%	February 26, 2007	**3,000**	3,000
3.82%	January 10, 2008	**3,000**	3,000
4.95%	March 26, 2008	**2,000**	-
5.22%	May 12, 2008	**2,000**	-
5.34%	July 14, 2008	**2,000**	-
4.88%	September 26, 2008	**2,000**	-
3.99%	February 25, 2009	**2,000**	2,000
Total term loans		**$ 16,000**	$ 15,000

(g) Interest rate floats monthly based on the 1 month LIBOR +1.75%. The interest rate was 7.07% and 6.11% at December 31, 2006 and 2005, 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, 2006 (in thousands):

2007	$ 54,858
2008	18,787
2009	2,000
2010	110
2011	20
Total borrowed funds	$ 75,775

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.

The Company adopted the recognition provisions of Statement of Financial Accounting Standards (FAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Post-retirement Plans* and initially applied them to the funded status of its defined benefit pension plan as of December 31, 2006. The initial recognition of the funded status of its defined benefit pension plan resulted in a decrease in stockholders' equity of $852,000, which was net of a tax benefit of $439,000.

The following table sets forth the incremental effect of applying FAS No. 158 on individual line items in the consolidated balance sheet at December 31, 2006 (in thousands):

	Before Application of FAS No. 158	Adjustments	After Application of FAS No. 158
Other assets	$ 9,101	$ 410	$ 9,511
Total assets	571,758	410	572,168
Other liabilities	2,829	1,262	4,091
Total liabilities	527,406	1,262	528,668
Accumulated other comprehensive loss	(885)	(852)	(1,737)
Total stockholders' equity	44,352	(852)	43,500
Total liabilities and stockholders' equity	571,758	410	572,168

The following table sets forth the obligation and funded status as of December 31 (in thousands):

	2006	2005
Change in benefit obligation		
Benefit obligation at beginning of year	**$ 6,165**	$ 5,784
Service cost	**388**	361
Interest cost	**363**	325
Amendments	**-**	3
Assumption change	**126**	(112)
Experience loss (gain)	**226**	(55)
Benefits paid	**(166)**	(141)
Benefit obligation at end of year	**7,102**	6,165
Change in plan assets		
Fair value of plan assets at beginning of year	**4,921**	4,599
Actual return on plan assets	**597**	127
Employer contribution	**444**	336
Benefits paid	**(166)**	(141)
Fair value of plan assets at end of year	**5,796**	4,921

Funded status	**$**	**(1,306)**	$	(1,244)

Amounts not yet recognized as a component of net periodic pension cost (in thousands):

Amounts recognized in accumulated other comprehensive loss consists of:				
Net loss	**$**	**1,615**	$	353
Prior service cost		**29**		-
Amounts not recognized in accumulated other comprehensive loss consists of:				
Net loss		**-**		1,199
Prior service cost		**-**		29
Total	**$**	**1,644**	$	1,581

The accumulated benefit obligation for the defined benefit pension plan was $5,605,000 and $4,966,000 at December 31, 2006 and 2005, respectively. Information where the accumulated benefit obligation is in excess of plan assets at December 31 is as follows (in thousands):

		2005
Projected benefit obligation	$	6,165
Accumulated benefit obligation		4,966
Fair value of plan assets		4,921

The components of net periodic benefit costs for the periods ending December 31 are as follows (in thousands):

		2006		2005		2004
Service cost	**$**	**388**	$	361	$	336
Interest cost		**363**		325		295
Return on plan assets		**(395)**		(376)		(332)
Net amortization and deferral		**86**		59		24
Net periodic benefit cost	**$**	**442**	$	369	$	323

The estimated net loss and prior service cost (benefit) that will be amortized from accumulated other comprehensive loss into the net periodic benefit cost in 2007 is $70,000 and $(1,000), respectively.

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

	2006	2005
Discount rate	**5.75%**	5.75%
Rate of compensation increase	**3.25%**	3.00%

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

	2006	2005	2004
Discount rate	**5.75%**	5.75%	5.75%
Expected long-term return on plan assets	**8.00%**	8.00%	8.00%
Rate of compensation increase	**3.25%**	3.00%	3.25%

The long-term rate of return on plan assets gives consideration to returns currently being earned on plan assets as well as future rates expected to be earned. 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, 2006 and 2005, by asset category are as follows:

Asset category:	**2006**	2005
Equity securities	67.2%	70.5%
Debt securities	**23.3**	28.3
Other	**9.5**	1.2
Total	100.0%	100.0%

Equity securities include the Company's common stock in the amounts of $230,000 (4.0% of total plan assets) and $224,000 (4.6% of total plan assets) at December 31, 2006 and 2005, respectively.
The Bank expects to contribute $444,000 to its pension plan in 2007. Expected future benefit payments that the Bank estimates from its pension plan are as follows (in thousands):

2007	$ 160
2008	177
2009	179
2010	218
2011	214
2012 - 2016	1,398

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 totaled $187,000 and $200,000 for 2006 and 2005, respectively.

Directors' Deferred Compensation Plan

The Company's directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. Amounts included in interest expense on the deferred amounts totaled $44,000, $35,000 and $32,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

2006 Restricted Stock Plan

Effective April 18, 2006, shareholders of the Company approved the 2006 Restricted Stock Plan (the Plan). Employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company's common stock and are subject to certain vesting requirements including continuous employment or service with the Company. 100,000 shares of the Company's common stock have been authorized under the Plan, which terminates April 18, 2016. The Plan assists the Company in attracting, retaining and motivating employees and non-employee directors to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation. As of December 31, 2006, no restricted stock awards have been awarded.

11. INCOME TAXES

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

	Year Ended December 31,		
	2006	2005	2004
Currently payable	**$ 1,348**	$ 1,410	$ 1,640
Deferred liability (asset)	**109**	256	(166)
Provision for income taxes	**$ 1,457**	$ 1,666	$ 1,474

The following temporary differences gave rise to the net deferred tax assets at December 31, 2006 and 2005 (in thousands):

	2006	2005
Deferred tax assets:		
Allowance for loan losses	**$ 1,187**	$ 1,078
Deferred compensation	**574**	564
Merger & acquisition costs	**45**	48
Allowance for losses on available-for-sale securities	**191**	247
Pension obligation	**444**	7
Unrealized losses on available-for-sale securities	**336**	673
Less valuation allowance	**(182)**	(182)
Total	**$ 2,595**	$ 2,435
Deferred tax liabilities:		
Premises and equipment	**$ (238)**	$ (275)
Investment securities accretion	**(34)**	(36)
Loan fees and costs	**(110)**	(115)
Goodwill and core deposit intangibles	**(419)**	(215)
Low income housing tax credits	**(36)**	(18)
Mortgage servicing rights	**(60)**	(70)
Total	**(897)**	(729)
Deferred tax asset, net	**$ 1,698**	$ 1,706

At December 31, 2006 and 2005, the valuation allowance was $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, 2006 and 2005, the Company did not have sufficient unrealized capital gains available to utilize the unrealized loss recognized on the Freddie Mac preferred stock.

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,		
	2006	2005	2004
Provision at statutory rates on			
pre-tax income	**$ 2,462**	$ 2,347	$ 2,287
Effect of tax-exempt income	(913)	(748)	(648)
Low income housing tax credits	(130)	(130)	(130)
Bank owned life insurance	(103)	(100)	(105)
Nondeductible interest	**118**	75	54
Valuation allowance	**-**	182	-
Other items	**23**	40	16
Provision for income taxes	**$ 1,457**	$ 1,666	$ 1,474
Statutory tax rates	34%	34%	34%
Effective tax rates	20.1%	24.1%	21.9%

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 for 2006 and 2005 with officers, directors, stockholders and associates of such persons is listed below (in thousands):

	Year Ended December 31,	
	2006	2005
Balance, beginning of year	**$ 2,464**	$ 3,090
New loans	**1,209**	1,272
Repayments	**(936)**	(1,898)
Balance, end of year	**$ 2,737**	$ 2,464

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 2007 without approval of the Comptroller of the Currency of approximately $6,230,000, plus the Bank's net income for 2007.

Loans:

The Bank is subject to regulatory restrictions which limit its ability to loan funds to the Company. At December 31, 2006, the regulatory lending limit amounted to approximately $4,852,000.

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, 2006 and 2005, the Federal Reserve Board categorized the Company and the Office of the Comptroller of the Currency categorized 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):

	2006		2005	
	Amount	**Ratio**	Amount	Ratio
Total capital (to risk weighted assets)				
Company	**$ 47,604**	**12.59%**	$ 44,731	12.88%
For capital adequacy purposes	**30,252**	**8.00%**	27,793	8.00%
To be well capitalized	**37,815**	**10.00%**	34,741	10.00%
Tier I capital (to risk weighted assets)				
Company	**$ 43,684**	**11.55%**	$ 41,067	11.82%
For capital adequacy purposes	**15,126**	**4.00%**	13,897	4.00%
To be well capitalized	**22,689**	**6.00%**	20,845	6.00%
Tier I capital (to average assets)				
Company	**$ 43,684**	**7.82%**	$ 41,067	8.04%
For capital adequacy purposes	**22,355**	**4.00%**	20,440	4.00%
To be well capitalized	**27,944**	**5.00%**	25,551	5.00%

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

	2006		2005	
	Amount	**Ratio**	Amount	Ratio
Total capital (to risk weighted assets)				
Bank	**$ 41,249**	10.93%	$ 37,203	10.72%
For capital adequacy purposes	**30,200**	8.00%	27,771	8.00%
To be well capitalized	**37,750**	10.00%	34,714	10.00%
Tier I capital (to risk weighted assets)				
Bank	**$ 37,330**	9.89%	$ 33,538	9.66%
For capital adequacy purposes	**15,100**	4.00%	13,886	4.00%
To be well capitalized	**22,650**	6.00%	20,828	6.00%
Tier I capital (to average assets)				
Bank	**$ 37,330**	6.68%	$ 33,538	6.57%
For capital adequacy purposes	**22,373**	4.00%	20,430	4.00%

To be well capitalized	**27,966**	5.00%	25,537	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, 2006 and 2005, are as follows (in thousands):

	2006	2005
Commitments to extend credit	**$ 59,856**	$ 56,767
Standby letters of credit	**2,071**	1,618

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 during 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,			
	2006		2005	
	Carrying Amount	**Estimated Fair Value**	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	**$ 10,015**	**$ 10,015**	$ 8,609	$ 8,609
Available-for-sale securities	**109,743**	**109,743**	102,602	102,602
Net loans	**410,897**	**413,498**	379,139	391,493
Bank owned life insurance	**8,047**	**8,047**	7,743	7,743
Regulatory stock	**3,996**	**3,996**	2,849	2,849
Accrued interest receivable	**2,458**	**2,458**	2,164	2,164
Financial liabilities:				
Deposits	**$ 446,515**	**$ 443,208**	$ 429,799	$ 426,966
Borrowed funds	**75,775**	**75,232**	52,674	52,426
Accrued interest payable	**2,287**	**2,287**	1,862	1,862

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

	December 31,	
(in thousands)	**2006**	2005
Assets:		
Cash	**$ 5,798**	$ 7,095
Investment in subsidiary:		
First Citizens National Bank	**44,644**	41,533
Other assets	**653**	453
Total assets	**$ 51,095**	$ 49,081
Liabilities:		
Other liabilities	**$ 95**	$ 20
Borrowed funds	**7,500**	7,500
Total liabilities	**7,595**	7,520
Stockholders' equity	**43,500**	41,561
Total liabilities and stockholders' equity	**$ 51,095**	$ 49,081

CITIZENS FINANCIAL SERVICES, INC.
CONDENSED STATEMENT OF INCOME

	Year Ended December 31,		
(in thousands)	**2006**	2005	2004
Dividends from:			
Bank subsidiary	**$ 3,038**	$ 2,825	$ 3,776
Available-for-sale securities	**2**	-	-
Total income	**3,040**	2,825	3,776
Expenses	**551**	470	377
Income before equity in undistributed earnings of subsidiary	**2,489**	2,355	3,399
Equity in undistributed earnings - First Citizens National Bank	**3,311**	2,919	1,868
Net income	**$ 5,800**	$ 5,274	$ 5,267

CITIZENS FINANCIAL SERVICES, INC.
STATEMENT OF CASH FLOWS

	Year Ended December 31,		
(in thousands)	**2006**	2005	2004
Cash flows from operating activities:			
Net income	**$ 5,800**	$ 5,274	$ 5,267
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	**(3,311)**	(2,919)	(1,868)
Other, net	**(18)**	(11)	(377)
Net cash provided by operating activities	**2,471**	2,344	3,022
Cash flows from investing activities:			
Purchases of available-for-sale securities	**(104)**	-	-
Net cash used in investing activities	**(104)**	-	-
Cash flows from financing activities:			
Cash dividends paid	**(2,442)**	(2,335)	(2,209)
Repayments of borrowed funds	**-**	-	(938)
Purchase of treasury stock	**(1,222)**	(463)	(6)
Net cash used in financing activities	**(3,664)**	(2,798)	(3,153)
Net decrease in cash	**(1,297)**	(454)	(131)
Cash at beginning of year	**7,095**	7,549	7,680
Cash at end of year	**$ 5,798**	$ 7,095	$ 7,549

17. CONSOLIDATED CONDENSED QUARTERLY DATA (UNAUDITED)

(in thousands, except share data)	Three Months Ended			
2006	**Mar 31**	**Jun 30**	**Sep 30**	**Dec 31**
Interest income	**$ 7,631**	**$ 8,076**	**$ 8,383**	**$ 8,761**
Interest expense	**3,264**	**3,598**	**3,916**	**4,175**
Net interest income	**4,367**	**4,478**	**4,467**	**4,586**
Provision for loan losses	**60**	**60**	**105**	**105**
Non-interest income	**1,138**	**1,186**	**1,208**	**1,180**
Investment securities gains (losses), net	**(6)**	**5**	**5**	**-**
Non-interest expenses	**3,891**	**3,737**	**3,698**	**3,701**
Income before provision for income taxes	**1,548**	**1,872**	**1,877**	**1,960**
Provision for income taxes	**272**	**386**	**329**	**470**
Net income	**$ 1,276**	**$ 1,486**	**$ 1,548**	**$ 1,490**
Earnings Per Share	**$ 0.44**	**$ 0.52**	**$ 0.55**	**$ 0.53**

	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	1,212
Investment securities gains (losses), net	-	-	-	-
Non-interest expenses	3,831	3,862	3,821	3,873
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	$ 0.44	$ 0.45	$ 0.46	$ 0.48

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 as 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, 2006 and 2005, 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, 2006. 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, 2006 and 2005, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

Wexford, Pennsylvania
February 26, 2007

FIVE YEAR SUMMARY OF OPERATIONS

(in thousands, except share data)	**2006**	2005	2004	2003	2002
Interest income	**$ 32,851**	$ 28,699	$ 26,606	$ 25,615	$ 27,377
Interest expense	**14,953**	11,000	9,235	8,826	10,404
Net interest income	**17,898**	17,699	17,371	16,789	16,973
Provision for loan losses	**330**	60	-	435	435
Net interest income after provision for loan losses	**17,568**	17,639	17,371	16,354	16,538
Non-interest income	**4,712**	4,688	4,527	4,759	4,792
Investment securities gains (losses), net	**4**	-	(235)	553	254
Non-interest expenses	**15,027**	15,387	14,922	15,501	14,226
Income before provision for income taxes and extraordinary item	**7,257**	6,940	6,741	6,165	7,358
Provision for income taxes	**1,457**	1,666	1,474	1,286	1,763
Net income	**$ 5,800**	$ 5,274	$ 5,267	$ 4,879	$ 5,595
Per share data:					
Net income (1)	**$ 2.04**	$ 1.83	$ 1.82	$ 1.67	$ 1.90
Cash dividends (1)	**0.86**	0.82	0.76	0.72	0.65
Book value (1) (2)	**16.04**	15.00	14.03	12.97	12.20
Total investments	**$ 109,743**	$ 102,602	$ 95,747	$ 106,587	$ 100,725
Loans, net (3)	**410,897**	379,139	355,774	314,037	294,836
Total assets (3)	**572,168**	529,241	499,347	463,878	432,658
Total deposits (3)	**446,515**	429,799	419,074	385,691	373,051
Stockholders' equity	**43,500**	41,561	40,789	38,529	38,406

(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 over-the-counter market. 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).

	2006			2005		
	High	**Low**	**Dividends paid per share**	High	Low	Dividends paid per share
First quarter	**$ 22.77**	**$ 20.54**	**$ 0.210**	$ 24.75	$ 23.50	$ 0.200
Second quarter	**23.76**	**21.38**	**0.215**	24.80	20.75	0.205
Third quarter	**23.01**	**21.38**	**0.215**	21.95	20.10	0.205
Fourth quarter	**22.80**	**21.05**	**0.220**	21.25	19.50	0.210

STOCK PERFORMANCE GRAPH

The Stock Price Performance Graph below shall not be deemed incorporated by reference by any general statement incorporating by reference this Annual Report into any filing under the Securities Act of 1933, as amended, or under the Securities Exchange Act of 1934, as amended, except to the extent that the Company specifically incorporates this information by reference, and shall not otherwise be deemed "filed" under such Acts.

The graph compares the Company's stock performance from December 31, 2001 through December 31, 2006, against the performance of the NASDAQ Composite and Mid-Atlantic Custom Peer Group for the same period. The graph shows the cumulative investment return to shareholders, based on the assumption that a $100 investment was made on December 31, 2001, in each of the Company's common stock, NASDAQ Composite, and the Mid-Atlantic Custom Peer Group, and that all dividends were reinvested in such securities over the past five fiscal years. Shareholder return shown on the graph below is not necessarily indicative of future performance.

	Period Ending					
Index	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**
Citizens Financial Services, Inc.	100.00	164.92	186.64	194.60	178.94	202.35
NASDAQ Composite	100.00	68.76	103.67	113.16	115.57	127.58
Mid-Atlantic Custom Peer Group*	100.00	119.20	178.39	200.93	198.36	208.68

* - Mid-Atlantic Custom Peer Group consists of Mid-Atlantic commercial banks with assets less than $1 billion.

Source : SNL Financial LC, Charlottesville, VA

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TRUST AND INVESTMENT SERVICES FUNDS UNDER MANAGEMENT

(market values - in thousands)		**2006**		2005
INVESTMENTS:				
Bonds	**$**	**17,543**	$	15,913
Stock		**21,013**		21,894
Savings and Money Market Funds		**9,163**		8,974
Mutual Funds		**32,678**		26,547
Mortgages		**951**		1,136
Real Estate		**1,263**		751
Miscellaneous		**16**		19
Cash		**10**		11
TOTAL	**$**	**82,637**	$	75,245
ACCOUNTS:				
Trusts		**26,333**		24,538
Guardianships		**144**		126
Employee Benefits		**30,253**		25,822
Investment Management		**24,742**		21,368
Custodial		**1,165**		3,391
TOTAL	**$**	**82,637**	$	75,245

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 also experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.

Except as required by applicable law and regulation, we assume no obligation to update or revise any forward-looking statements after the date on which they are made.

INTRODUCTION

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for 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 condition 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 of 2005, regulatory approval was received to purchase the Hannibal branch of the Fulton Savings Bank in Hannibal, New York (see footnote 18 of the consolidated financial statements). The office was relocated to Wellsville, New York, where a temporary banking facility was utilized. In October, 2006, we officially opened our newly constructed de novo branch facility in Wellsville, accomplishing one of our primary objectives of expanding into New York State.

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. We can not anticipate additional requirements or additional compliance efforts regarding the Bank Secrecy Act or USA Patriot Act, or regulatory burdens regarding the ever increasing information theft and fraudulent activities impacting our customers and the banking industry in general.

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 annual reports on Form 10-K, 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. The financial services industry continues to experience tremendous change to competitive barriers between bank and non-bank institutions. We must compete not only with traditional financial institutions, but in addition, with 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 Division is committed to helping our customers meet their financial goals. The Trust Division offers professional trust administration, investment management services, estate planning and administration, custody of securities and individual retirement 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, 2006, the Trust Department had $82.6 million of assets under management. This compares to $75.2 million as of December 31, 2005.

Our Financial Consultants offer full service brokerage services throughout the Bank's market area. Appointments can be made at any First Citizens National Bank branch. The Financial Consultants 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 ended December 31, 2006 was $5,800,000, which represents an increase of $526,000, or 10.0%, when compared to the 2005 related period. Net income for the twelve months ended December 31, 2005 totaled $5,274,000, a slight increase of $7,000 from the 2004 related period. Earnings per share were $2.04, $1.83 and $1.82 for the years ended 2006, 2005 and 2004, 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:

	2006	2005	2004
Return on Assets (net income to average total assets)	**1.05%**	1.04%	1.09%
Return on Equity (net income to average total equity)	**13.21%**	12.63%	13.40%
Dividend Payout Ratio (dividends declared divided by net income)	**42.10%**	44.28%	41.90%
Equity to Asset Ratio (average equity to average total assets, excluding other comprehensive income)	**7.98%**	8.20%	8.15%

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)

	2006			2005			2004		
	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	**4**	**0**	**5.14**	114	3	2.63	986	10	1.01
Total short-term investments	**4**	**0**	**5.14**	114	3	2.63	986	10	1.01
Investment securities:									
Taxable	**86,198**	**3,892**	**4.52**	83,787	3,236	3.86	97,595	3,779	3.87
Tax-exempt (3)	**22,952**	**1,368**	**5.96**	14,705	903	6.14	6,881	456	6.63
Total investment securities	**109,150**	**5,260**	**4.82**	98,492	4,139	4.20	104,476	4,235	4.05
Loans:									
Residential mortgage loans	**209,305**	**14,842**	**7.09**	201,265	13,814	6.86	192,596	13,363	6.94
Commercial & agricultural loans	**134,813**	**10,353**	**7.68**	118,524	8,434	7.12	98,064	6,678	6.81
Loans to state & political subdivisions	**43,642**	**2,604**	**5.97**	38,766	2,308	5.95	35,878	2,183	6.08
Other loans	**12,747**	**1,141**	**8.95**	12,592	1,106	8.78	12,298	1,100	8.94
Loans, net of discount (2)(3)(4)	**400,507**	**28,940**	**7.23**	371,147	25,662	6.91	338,836	23,324	6.88
Total interest-earning assets	**509,661**	**34,200**	**6.71**	469,753	29,804	6.34	444,298	27,569	6.21
Cash and due from banks	**9,093**			8,764			8,450		
Bank premises and equipment	**12,415**			12,142			11,169		
Other assets	**18,610**			18,714			18,495		
Total non-interest earning assets	**40,118**			39,620			38,114		
Total assets	**549,779**			509,373			482,412		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									
NOW accounts	**85,481**	**1,638**	**1.92**	71,257	665	0.93	63,210	268	0.42
Savings accounts	**39,170**	**130**	**0.33**	39,939	113	0.28	39,434	111	0.28
Money market accounts	**45,717**	**1,464**	**3.20**	49,482	999	2.02	44,607	481	1.08
Certificates of deposit	**218,019**	**8,453**	**3.88**	213,109	7,596	3.56	211,325	7,423	3.51
Total interest-bearing deposits	**388,387**	**11,685**	**3.01**	373,787	9,373	2.51	358,576	8,283	2.31

Other borrowed funds	**63,635**	**3,268**	**5.14**	41,893	1,627	3.88	35,117	952	2.71
Total interest-bearing liabilities	**452,022**	**14,953**	**3.31**	415,680	11,000	2.65	393,693	9,235	2.35
Demand deposits	**49,324**			46,890			44,763		
Other liabilities	**4,757**			5,033			4,637		
Total non-interest-bearing liabilities	**54,081**			51,923			49,400		
Stockholders' equity	**43,676**			41,770			39,319		
Total liabilities & stockholders' equity	**549,779**			509,373			482,412		
Net interest income		**19,247**			18,804			18,334	
Net interest spread (5)			**3.40%**			3.69%			3.86%
Net interest income as a percentage of average interest-earning assets			**3.78%**			4.00%			4.13%
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 $509,000, $354,000 and $239,000 for investments and $840,000, $751,000 and $724,000 for loans have been made accordingly to the previous table for the years ended December 31, 2006, 2005 and 2004, 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)

	2006 vs. 2005 (1)			2005 vs. 2004 (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	**$ (5)**	**$ 2**	**$ (3)**	$ (14)	$ 7	$ (7)
Investment securities:						
Taxable	**90**	**566**	**656**	(533)	(10)	(543)
Tax-exempt	**493**	**(28)**	**465**	482	(35)	447
Total investment securities	**583**	**538**	**1,121**	(51)	(45)	(96)
Loans:						
Residential mortgage loans	**658**	**370**	**1,028**	596	(145)	451
Commercial & agricultural loans	**1,376**	**543**	**1,919**	1,473	283	1,756
Loans to state & political subdivisions	**291**	**5**	**296**	173	(48)	125
Other loans	**14**	**21**	**35**	26	(20)	6
Total loans, net of discount	**2,339**	**939**	**3,278**	2,268	70	2,338
Total Interest Income	**2,917**	**1,479**	**4,396**	2,203	32	2,235
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	**100**	**873**	**973**	29	368	397
Savings accounts	**(3)**	**20**	**17**	2	-	2
Money Market accounts	**(81)**	**546**	**465**	45	473	518
Certificates of deposit	**170**	**687**	**857**	62	111	173
Total interest-bearing deposits	**186**	**2,126**	**2,312**	138	952	1,090
Other borrowed funds	**1,562**	**79**	**1,641**	120	555	675
Total interest expense	**1,748**	**2,205**	**3,953**	258	1,507	1,765
Net interest income	**$ 1,169**	**$ (726)**	**$ 443**	$ 1,945	$ (1,475)	$ 470

(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.

2006 vs. 2005

As shown in the preceding tables, tax equivalent net interest income for 2006 was $19,247,000 compared with $18,804,000 for 2005, an increase of $443,000 or 2.4%. The increased volume of interest earning assets of $39.9 million generated an increase in interest income of $2,917,000. The average rate on interest earning assets increased from 6.34% in 2005 to 6.71% in 2006, which had the effect of increasing interest income by $1,479,000. The average balance of interest bearing liabilities increased $36.3 million, which had the effect of increasing total interest expense by $1,748,000. Furthermore, the average rate on interest bearing liabilities increased from 2.65% to 3.31%, which had the effect of increasing interest expense by $2,205,000 due to the flattened, and at times inverted, yield curve as discussed below.

Loan income increased $3,278,000 in 2006 from 2005. Our commitment and focus on originating good quality, commercial loans was the primary driver as income from these loans increased $1,919,000 over 2005. The average balance of commercial loans increased $16.3 million or 13.74%, while at the same time the average rate increased from 7.12% to 7.68%.

Residential mortgage loan income increased $1,028,000. The increase due to volume was $658,000, as the average balance increased $8.0 million. The average rate earned on these loans went from 6.86% to 7.09%, which had the effect of increasing interest income by $370,000. The Company continues to strive on being the top mortgage lender within our service area by providing competitive products and exemplary service to our customers.

Total tax equivalent interest income from investment securities increased $1,121,000 in 2006 from 2005. Income from taxable investment securities increased $656,000. The average rate earned went from 3.86% to 4.52%, which had the effect of increasing income by $566,000. Interest income from tax-exempt investment securities increased $465,000 in 2006. The Company's strategy, particularly in the latter half of 2005, 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 $2,312,000 in 2006 from 2005. The increase due to volume was $186,000 while the increase due to rate was $2,126,000. The continued increase in short term rates, reflective of the 100 basis point increase in the federal funds rate since the beginning of 2006, 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 $1,641,000 in 2006.

From June, 2004 through June, 2006, the Federal Reserve increased the Federal Funds rate from 1.00% to 5.25%. This has had a significant impact on the rates paid on short term deposits, top tier money market and NOW accounts, and on short term borrowing rates particularly from the Federal Home Loan Bank. During this same period, longer term interest rates have not increased at the same pace, resulting in a flattened yield curve. The flattened yield curve, which at times has been inverted, has persisted for all of 2006 as well as 2005. This has dampened our ability to increase the average rates on interest earning assets at the same rate 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 a result, our net interest spread has decreased from 3.86% in 2004 to 3.69% in 2005, with a further decline to 3.40% in 2006. As the interest rate environment returns to a more normal yield curve, it is anticipated that the Company's net interest spread should improve. Should the flattened to inverted yield curve continue to remain in effect for an extended period, we will continue to see additional pressure on our margin.

2005 vs. 2004

Tax equivalent net interest income increased from $18,334,000 in 2004 to $18,804,000 in 2005, which is 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 while increased volume of interest-bearing liabilities of $22.0 million produced an additional $258,000 of interest expense. The change in volume resulted in a net increase of $1,945,000 in net interest income. The net change in rate was a negative $1,475,000 resulting in a total positive net change of $470,000 when combined with the change in volume.

Interest income on loans increased $2,338,000. The amount of increase related to loan volume was $2,268,000 while the increase related to rate was $70,000. The average balance of loans increased $32.3 million from 2004 to 2005.

Interest expense on interest bearing deposits increased $1,090,000. The amount attributable to the change in average rate resulted in an increase in interest expense of $952,000, while the increase due to volume was $138,000. Interest expense on borrowed funds increased $675,000 compared with 2004. The increase due to volume totaled $120,000, while the increase due to rate was $555,000. The average rate paid on interest-bearing liabilities increased from 2.35% in 2004 to 2.65% in 2005.

2005's net interest income compared to 2004 shows the effects of increasing short-term interest rates and the effect of a flattening of the yield curve as described above. During 2005, the Federal Reserve increased short-term interest rates by 200 basis points, in 25 basis point increments throughout the year, while long-term rates remained relatively unchanged.

Non-interest Income

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

	2006	2005	2004
Service charges	**$ 3,140**	$ 2,965	$ 3,017
Trust	**487**	474	434
Brokerage	**166**	183	185
Insurance	**94**	260	175
Gains on loans sold	**68**	70	54
Investment securities gains (losses), net	**4**	-	(235)
Earnings on bank owned life insurance	**304**	294	307
Other	**453**	442	355
Total	**$ 4,716**	$ 4,688	$ 4,292

	2006/2005 Change		2005/2004 Change	
	Amount	%	Amount	%
Service charges	**$ 175**	**5.9**	$ (52)	(1.7)
Trust	**13**	**2.7**	40	9.2
Brokerage	**(17)**	**(9.3)**	(2)	(1.1)
Insurance	**(166)**	**(63.8)**	85	48.6
Gains on loans sold	**(2)**	**(2.9)**	16	29.6
Investment securities gains (losses), net	**4**	**-**	235	(100.0)
Earnings on bank owned life insurance	**10**	**3.4**	(13)	(4.2)
Other	**11**	**2.5**	87	24.5
Total	**$ 28**	**0.6**	$ 396	9.2

2006 vs. 2005

Non-interest income increased $28,000 in 2006 from 2005, or .6%. Service charge income increased by $175,000 in 2006 compared to 2005. This increase was offset by a decrease in insurance revenue of $166,000. Other categories listed were comparable to income recognized in 2005.

Service charge fees charged to customers for non-sufficient funds increased by $134,000. The opening of over 3,000 new checking accounts contributed to this increase. ATM and check card related fee income also increased by $67,000 due to continued promotional efforts to increase retail customers' usage of their debit cards. Offsetting these was a $34,000 decrease in statement fees, primarily due to the competitive environment for attracting and retaining commercial deposit customers.

Trust revenues increased $13,000 from 2005, reflecting our efforts to continue growing trust assets under management. Brokerage and insurance revenues decreased in 2006 by $17,000 and $166,000, respectively. During 2006, the Company changed our broker dealer relationship in order to improve service and enhance our ability to meet the needs of our customers. This change, coupled with several large annuity transactions recognized in 2005, had the impact of reducing brokerage and insurance revenues in 2006 compared with last year. The new broker dealer relationship, plus the addition of a financial consultant during 2006, should enable the Company to grow future revenues while expanding customer service.

2005 vs. 2004

Non-interest income increased $396,000 in 2005 compared with 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.

Non-interest Expenses

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

	2006	2005	2004
Salaries and employee benefits	**$ 8,026**	$ 7,645	$ 7,636
Occupancy	**1,123**	1,142	1,072
Furniture and equipment	**593**	658	695
Professional fees	**551**	536	630
Amortization of intangibles	**252**	578	506
Other	**4,482**	4,828	4,383
Total	**$ 15,027**	$ 15,387	$ 14,922

	2006/2005 Change		2005/2004 Change	
	Amount	%	Amount	%
Salaries and employee benefits	**$ 381**	**5.0**	$ 9	0.1
Occupancy	**(19)**	**(1.7)**	70	6.5
Furniture and equipment	**(65)**	**(9.9)**	(37)	(5.3)
Professional fees	**15**	**2.8**	(94)	(14.9)
Amortization of intangibles	**(326)**	**(56.4)**	72	14.2
Other	**(346)**	**(7.2)**	445	10.2
Total	**$ (360)**	**(2.3)**	$ 465	3.1

		2006		2005		2004
Other professional fees	$	**296**	$	286	$	384
Legal fees		**115**		116		101
Examinations and audits		**140**		134		145
Total	$	**551**	$	536	$	630

		2006/2005 Change			2005/2004 Change	
		Amount	%		Amount	%
Other professional fees	$	**10**	**3.5**	$	(98)	(25.5)
Legal fees		**(1)**	**(0.9)**		15	14.9
Examinations and audits		**6**	**4.5**		(11)	(7.6)
Total	$	**15**	**2.8**	$	(94)	(14.9)

2006 vs. 2005

Non-interest expenses for 2006 of $15,027,000 decreased $360,000, or 2.3%, compared with 2005 costs of $15,387,000. Salaries and benefit costs increased $381,000, which were offset by decreases in furniture and equipment expenses, amortization of intangibles and other expenses.

Operating expenses related to our de novo office in Wellsville, New York, added significant costs during 2006. This includes approximately $259,000 of costs related to personnel, furniture and equipment, occupancy and other expenses.

Base salaries increased $90,000, or 1.5%, primarily due to merit increases. Full time equivalent staffing was 172, unchanged from last year. Employee health insurance costs increased $86,000 while pension expenses increased $72,000. Incentive costs increased $128,000 compared with 2005.

Amortization expense decreased by $326,000 this year compared to 2005 due to the core deposit intangible related to a past acquisition in 2000 becoming fully amortized in March, 2006. Furniture and equipment expense decreased by $65,000 compared to 2005 mainly due to depreciation expense from assets becoming fully depreciated. Other expenses decreased $346,000 in 2006. Of this decrease, $240,000 was attributable to a decrease in merger and acquisition costs related to the Fulton acquisition in 2005 (see Footnote 18 of the consolidated financial statements for additional information). Total professional fees expense totaled $551,000 in 2006, compared to $536,000 in 2005, a modest increase of $15,000 or 2.8%.

2005 vs. 2004

Non-interest expenses increased $465,000, or 3.1% over 2004. Salary and benefits increased a modest $9,000. Base salaries increased $255,000 due to merit increases and a slight increase in full time equivalent staff from 171 to 172. Employee insurance and pension costs increased $62,000 and $47,000, respectively. This was offset by a decrease in incentive payments compared to 2004 of $355,000.

Occupancy expenses increased due to several factors including an overall increase in real estate taxes, an increase in general maintenance costs and the addition of the Elmira Street branch acquired in July of 2004 related to the Legacy Branch acquisition (see Footnote 18 of the consolidated financial statements for additional information).

Amortization of intangible assets increased $72,000. This was the result of adding $790,000 of intangible assets in June, 2004 related to the Legacy branch acquisition, which is being amortized over 5 ½ years.

Professional fees decreased $94,000 from 2004, which reflected our continued efforts to scrutinize the use of consultants utilized by the Company.

Other expenses increased $445,000 due primarily to expenses recognized from the Fulton branch acquisition in December, 2005 (see Footnote 18 of the consolidated financial statements for additional information). $240,000 of non-recurring expenses were incurred for the Fulton acquisition during 2005.

Provision For Income Taxes

The provision for income taxes was $1,457,000 during 2006, $1,666,000 during 2005 and $1,474,000 for the 2004 related period. The effective tax rates for 2006, 2005 and 2004 were 20.1%, 24.1% and 21.9%, respectively.

Income before the provision for income taxes increased by $317,000 in 2006 compared to 2005. Although income increased, the provision for income taxes actually decreased by $209,000 when compared to 2005. The decrease is primarily a result of increasing our tax-exempt municipal security and municipal loan income. By increasing our tax-exempt income, we were able to decrease our effective tax rate for 2006.

The increase in 2005 is related to the $199,000 increase in taxable income from 2004. However, the most significant factor was the recording of a valuation allowance in 2005 totaling $182,000 related to unrealized losses on investment securities (see Footnote 11 of the consolidated financial statements for additional information). Excluding the valuation allowance, the effective tax rate for 2005 would have been 21.4%.

We are also involved in two limited partnership agreements that established low-income housing projects in our market area. We expect to recognize a total of approximately $1,296,000 of tax credits over a ten-year period. For tax purposes, we have recognized $571,000 out of a total $913,000 from one project and $192,000 out of a total $385,000 on the second project. In 2005, we entered into a third limited partnership for a low-income housing project for senior citizens in our Sayre market area, which was completed at the end of 2006. We will begin to recognize approximately $574,000 of tax credits beginning in 2007 over a 10-year period.

FINANCIAL CONDITION

The following table presents ending balances (dollars in millions), growth and the percentage change during the past two years:

	2006 Balance	**Increase**	**% Change**	2005 Balance	Increase	% Change	2004 Balance
Total assets	**$ 572.2**	**$ 43.0**	**8.1**	$ 529.2	$ 29.9	6.0	$ 499.3
Total loans, net	**410.9**	**31.8**	**8.4**	379.1	23.3	6.5	355.8
Total investments	**109.7**	**7.1**	**6.9**	102.6	6.9	7.2	95.7
Total deposits	**446.5**	**16.7**	**3.9**	429.8	10.7	2.6	419.1
Total stockholders' equity	**43.5**	**1.9**	**4.6**	41.6	0.8	2.0	40.8

Cash and Cash Equivalents

Cash and cash equivalents totaled $10.0 million at December 31, 2006 compared with $8.6 million at December 31, 2005. We believe the Company’s liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, Federal Home Loan Bank financing, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. These sources of funds should permit us to meet cash obligations and off-balance sheet commitments as they come due.

Investments

2006

Our investment portfolio increased by $7.1 million or 6.9% in 2006. The increase was primarily attributable to an increase in US Agency securities and mortgage-backed securities of $3.9 million and $4.0 million, respectively. This was offset by a decrease of $.6 million in corporate bonds. During 2006, we had maturities of $7.9 million and principal repayments of our mortgage-backed securities of $10.8 million. In an effort to improve the overall yield of the portfolio, we also sold $10.4 million of our securities and reinvested at higher current market yields. Included was the sale of 15,800 shares of Freddie Mac Preferred stock in order to utilize capital gains recognized in prior tax years. Our investment portfolio yielded 4.82% in 2006 compared to 4.20% a year ago, on a tax-equivalent basis.

2005

The Company's investment portfolio increased $6.9 million as of December 31, 2005 compared with 2004's ending balance. Most of the increase was attributable to US Agency securities and municipal bonds of $6.9 million and $15.2 million, respectively, which were offset by a decrease in mortgage-backed securities of $14.6 million. Due to the flattened yield curve, the Company's strategy for approximately the first two-thirds of 2005 was to use continued cash flows from the mortgage-backed securities portfolio to fund loan growth. In the later part of 2005, we invested in longer termed municipal bonds in order to maximize yield given the continued interest rate environment that we faced. As can be seen from the table below, the percentage of the Company's portfolio comprised of municipal securities increased from 7.8% to 22.0% as of the end of December. The percentage of the portfolio made up of US Agency securities totaled 12.5% compared to 6.1% last year.

The following table shows the year-end composition of the investment portfolio for the five years ending December 31 (dollars in thousands):

	2006 Amount	**% of Total**	2005 Amount	% of Total	2004 Amount	% of Total	2003 Amount	% of Total	2002 Amount	% of Total
Available-for-sale:										
U. S. Agency securities	**$ 16,651**	**15.2**	$ 12,754	12.5	$ 5,812	6.1	$ 1,033	1.0	$ 1,052	1.0
Obligations of state & political subdivisions	**22,562**	**20.5**	22,612	22.0	7,452	7.8	8,303	7.8	12,731	12.6
Corporate obligations	**7,997**	**7.3**	8,627	8.4	8,935	9.3	14,674	13.8	21,156	21.0
Mortgage-backed securities	**59,875**	**54.6**	55,852	54.4	70,449	73.6	78,376	73.5	60,801	60.4
Equity securities	**2,658**	**2.4**	2,757	2.7	3,099	3.2	4,201	3.9	4,985	5.0
Total	**$ 109,743**	**100.0**	$ 102,602	100.0	$ 95,747	100.0	$ 106,587	100.0	$ 100,725	100.0

The expected principal repayments (amortized cost) and average weighted yields for the investment portfolio as of December 31, 2006, are shown below (dollars in thousands). Expected principal repayments, which include prepayment speed assumptions for mortgage-backed securities, are significantly different than the contractual maturities detailed in Footnote 3 of the consolidated financial statements. Yields on tax-exempt securities are presented on a fully taxable equivalent basis, assuming a 34% tax rate.

	Within One Year	Yield (%)	One-Five Years	Yield (%)	Five-Ten Years	Yield (%)	After Ten Years	Yield (%)	Amortized Cost Total	Yield (%)
Available-for-sale securities:										
U.S. Agency securities	$ 2,999	5.1	$ 11,702	5.0	$ 1,946	5.4	$ -	-	$ 16,647	5.1
Obligations of state & political subdivisions	928	6.3	11,887	5.8	9,776	6.2	-	-	22,591	6.0
Corporate obligations	-	-	-	-	7,981	5.5	-	-	7,981	5.5
Mortgage-backed securities	196	4.8	45,062	4.2	15,692	5.7	-	-	60,950	4.6
Total available-for-sale	$ 4,123	5.4	$ 68,651	4.6	$ 35,395	5.8	$ -	-	$ 108,169	5.0

Approximately 68% of the amortized cost of debt securities is expected to mature, call or pre-pay within five years or less. Our Company expects that earnings from operations, the high liquidity level of the available-for-sale securities, growth of deposits and the availability of borrowings from the Federal Home Loan Bank and other third party banks will be sufficient to meet future liquidity needs. There are no securities from a single issuer representing more than 10% of stockholders' equity.

Loans

Historically, our loan customers have been located in North Central Pennsylvania and the Southern Tier of New York. We originate loans primarily through direct loans to our existing customer base, with new customers generated by referrals from real estate brokers, building contractors, attorneys, accountants and existing customers.

All lending is governed by a lending policy that is developed and maintained by us and approved by the Board of Directors. Our Company's real estate loan lending policy generally permits the Bank to lend up to 85% of the appraised value or purchase price (whichever is lower) on owner-occupied residential property, when secured by the first mortgage on the property. Home equity lines of credit or second mortgage loans are generally originated subject to maximum mortgage liens against the property of 85% of the current appraised value. The maximum term for mortgage loans is 30 years for one-to-four family residential property and 20 years for commercial and vacation property.

Overall, the local economy has remained relatively stable in 2006, with the local average unemployment rate remaining stable with last year at approximately 5.1%. This is above the state unemployment rate of 4.5%.

2006

As evidenced in the table below, total loans grew $32.0 million, or 8.4% in 2006 from a balance of $382.8 million at the end of 2005 to $414.8 million at the end of 2006. The primary increases were in residential real estate, commercial real estate, agricultural real estate, and other commercial loans which increased $10.4, $12.0, $4.1, and $3.5 million, respectively. The loan growth in 2006 of 8.4% compares to the 6.4% loan growth in 2005.

Residential real estate loans increased $10.4 million primarily due to the continued, favorable interest rate environment for home mortgages from a historical perspective. Due to the prolonged flat yield curve, long-term rates including mortgages and home equity loans, have remained relatively flat despite the sharp increase in short-term interest rates. Mortgage lending continues to be one of our primary focuses, as residential real estate loans totaled $206.1 million and comprised 49.7% of the loan portfolio as of the end of the year. One of our primary goals is to continue being the premier mortgage lender in our market area, with a variety of mortgage products available for our customers. We expect residential real estate loan demand to remain steady in 2007, subject to unexpected changes in interest rates, economic conditions or the overall housing market. In 2006, $3.3 million in conforming mortgage loans were originated and sold in the secondary market through Freddie Mac and Fannie Mae, providing nearly $44,000 of income in origination fees and premiums on loans sold.

Commercial loans increased $12.0 million in 2006. The Company has focused on increasing its good quality commercial loan portfolio in order to achieve improved organic loan growth, increase overall loan portfolio yields, deepen our relationship with customers and leverage the experience of our strong team of seasoned business development officers. As started in 2005, the Company has begun to expand its portfolio of agricultural loans, as $4.1 million of agricultural loans were added in 2006. This represents a 31.3 % increase and is reflective of our goal to better serve agricultural customers within our service area. Other commercial loans also increased $3.5 million, or 12.0% in 2006. We are cautiously optimistic that the demand for commercial loans, without compromising credit quality, will be stable in 2007. However, this demand is subject to significant competitive pressures, the yield curve and the strength of the overall local, regional and national economy.

2005

Total loans grew by $23.1 million in 2005, or 6.4%. Residential loans increased by $5.8 million, or 3.1% in 2005. Residential loans comprised 51.1% of the total loan portfolio and represented a balance of $195.6 million as of the end of December, 2005. While overall residential real estate loans have increased over the last several years, the percent of the portfolio made up of residential real estate mortgages has continued to decrease over the same periods due to the increased focus on commercial loans.

State and political loans increased by $7.4 million, or 21.2% compared to the end of 2004. This was primarily due to a $6.0 million loan to a local school district. We actively grew our municipal income in order to begin lowering our effective tax rate. Commercial real estate loans also increased by $6.9 million, or 9.2% in 2005 compared to 2004. In 2005, $5.4 million in conforming mortgage loans were originated and sold in the secondary market through Freddie Mac, providing nearly $70,000 of income in origination fees and premiums on loans sold.

Five Year Breakdown of Loans by Type as of December 31,

	2006		2005		2004		2003		2002	
(dollars in thousands)	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate:										
Residential	**$ 206,059**	**49.7**	$ 195,628	51.1	$ 189,803	52.8	$ 180,333	56.8	$ 175,323	58.7
Commercial	**94,122**	**22.7**	82,128	21.5	75,228	20.9	57,370	18.1	47,210	15.8
Agricultural	**17,054**	**4.1**	12,991	3.4	11,564	3.2	7,594	2.4	9,844	3.3
Construction	**7,027**	**1.7**	7,245	1.9	7,282	2.0	5,784	1.8	5,009	1.7
Loans to individuals for household, family and other purchases	**12,482**	**3.0**	13,017	3.4	12,657	3.5	13,145	4.1	13,915	4.7
Commercial and other loans	**32,766**	**7.9**	29,260	7.6	28,069	7.8	16,219	5.1	18,564	6.2
State & political subdivision loans	**45,263**	**10.9**	42,534	11.1	35,090	9.8	37,212	11.7	28,592	9.6
Total loans	**414,773**	**100.0**	382,803	100.0	359,693	100.0	317,657	100.0	298,457	100.0
Less allowance for loan losses	**3,876**		3,664		3,919		3,620		3,621	
Net loans	**$ 410,897**		$ 379,139		$ 355,774		$ 314,037		$ 294,836	

2006/2005 Change	2005/2004 Change

	Amount	%	Amount	%
Real estate:				
Residential	**$ 10,431**	**5.3**	$ 5,825	3.1
Commercial	**11,994**	**14.6**	6,900	9.2
Agricultural	**4,063**	**31.3**	1,427	12.3
Construction	**(218)**	**(3.0)**	(37)	(0.5)
Loans to individuals for household, family and other purchases	**(535)**	**(4.1)**	360	2.8
Commercial and other loans	**3,506**	**12.0**	1,191	4.2
State & political subdivision loans	**2,729**	**6.4**	7,444	21.2
Total loans	**$ 31,970**	**8.4**	$ 23,110	6.4

The following table shows the maturity of state and political subdivision loans, commercial and agricultural loans and commercial loans secured by real estate as of December 31, 2006, classified according to the sensitivity to changes in interest rates within various time intervals (in thousands):

	Commercial, municipal, agricultural	Real estate construction	Total
Maturity of loans:			
One year or less	$ 5,882	$ -	$ 5,882
Over one year but less than five years	27,067	469	27,536
Over five years	156,256	6,558	162,814
Total	$ 189,205	$ 7,027	$ 196,232
Sensitivity of loans to changes in interest rates - loans due after one year:			
Predetermined interest rate	$ 39,878	$ 1,962	$ 41,840
Floating or adjustable interest rate	143,445	5,065	148,510
Total	$ 183,323	$ 7,027	$ 190,350

Loan Quality and Provision For Loan Losses

As discussed previously, the loan portfolio contains a large portion of real estate secured loans (generally residential home mortgages, mortgages on small business properties, etc.), consumer installment loans and other commercial loans. Footnote 4 of the consolidated financial statements provides further details on the composition of the loan portfolio.

The following table indicates the level of non-performing assets over the past five years ending December 31 (dollars in thousands):

	2006	2005	2004	2003	2002
Non-performing loans:					
on-accruing loans	**$ 478**	$ 867	$ 722	$ 578	$ 1,064
Impaired loans	**1,190**	1,031	1,061	1,926	1,916
Accrual loans - 90 days or more past due	**1,690**	337	437	185	39
Total non-performing loans	**3,358**	2,235	2,220	2,689	3,019
Foreclosed assets held for sale	**758**	619	712	305	221
Total non-performing assets	**$ 4,116**	$ 2,854	$ 2,932	$ 2,994	$ 3,240
Non-performing loans as a percent of loans net of unearned income	**0.81%**	0.58%	0.62%	0.85%	1.01%
Non-performing assets as a percent of loans net of unearned income	**0.99%**	0.75%	0.82%	0.94%	1.09%

The increase in accrual loans - 90 days or more past due from 2005 to 2006 is primarily due to a temporary delay in payment from one large commercial loan customer totaling $1.1 million. Subsequent to the end of the year, the loan became current as expected.

Other than those disclosed above, we do not believe there are any loans classified for regulatory purposes as loss, doubtful, substandard, special mention or otherwise, which will result in losses or have a material impact on future operations, liquidity or capital reserves. We are not aware of any other information that causes us to have serious doubts as to the ability of borrowers in general to comply with repayment terms.

The following table presents an analysis of the allowance for loan losses for the five years ending December 31 (dollars in thousands):

Summary of Loan Loss Experience

	2006	2005	2004	2003	2002
Balance					
at beginning of period	**$ 3,664**	$ 3,919	$ 3,620	$ 3,621	$ 3,250
Charge-offs:					
Real estate-mortgage	**37**	43	110	68	59
Loans to individuals for household,					
family and other purchases	**118**	168	70	140	90
Commercial and other loans	**135**	161	135	344	30
Total loans charged-off	**290**	372	315	552	179
Recoveries:					
Real estate-mortgage	**6**	2	-	33	14
Loans to individuals for household,					
family and other purchases	**44**	12	25	63	34
Commercial and other loans	**122**	43	299	20	67
Total loans recovered	**172**	57	324	116	115
Net loans charged-off (recovered)	**118**	315	(9)	436	64
Provision charged to expense	**330**	60	-	435	435
Increase related to acquisition	**-**	-	290	-	-
Balance at end of year	**$ 3,876**	$ 3,664	$ 3,919	$ 3,620	$ 3,621
Loans outstanding at end of year	**$ 414,773**	$ 382,803	$ 359,693	$ 317,657	$ 298,457
Average loans outstanding, net	**$ 400,507**	$ 371,147	$ 338,836	$ 306,776	$ 285,241
Net charge-offs to average loans	**0.03%**	0.08%	0.00%	0.14%	0.02%
Year-end allowance to total loans	**0.93%**	0.96%	1.09%	1.14%	1.21%
Year-end allowance to total non-performing loans	**115.43%**	163.94%	176.53%	134.62%	119.94%

As detailed in the above tables, total non-performing loans increased $1,123,000 from December 31, 2005 to December 31, 2006. The percent of non-performing loans to total loans increased from .58% to .81% as of the end of December. Total loans charged-off in 2006 totaled $290,000, a decrease of $82,000 compared to last year. Total loans recovered were $172,000, resulting in a net charge-off for the year of $118,000 compared to $315,000 in 2005. $330,000 was charged to the provision in 2006 compared to $60,000 in 2005. During 2005 there were $372,000 of loans charged-off while $57,000 of loans were recovered, resulting in a net charge-off of $315,000.

Allowance For Loan Losses

The allowance is maintained at a level, which in management's judgment is adequate to absorb probable future loan losses inherent in the loan portfolio. The amount of the allowance is determined by a formal analysis of delinquencies, large problem credits, non-accrual loans, local economic conditions, trends in the loan portfolio and historic and projected losses. As part of this evaluation, the loan portfolio is divided into several categories in order to appropriately measure the risks within the portfolio. These categories are loans classified on the Watch List, residential mortgages, commercial loans and consumer loans.

Historical loss factors are calculated for consumer, residential mortgage, and commercial loans for the past seven years. The five year average historical loss factor for each category is applied to the performing portion of the loan category. For Watch List loans, the losses are calculated using regulatory guidelines and are based on historical losses. These historical factors, for both the Watch List and homogeneous loan pools, are adjusted based on the five following qualitative factors:

- Level of Delinquencies and Non-Accruals
- Trends in Volume and Terms of Loans
- Experience, Ability and Depth of Management
- National and Local Economic Trends and Conditions
- Concentration of Credit

While we evaluate all of this information quarterly, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. In addition, various regulatory agencies, as an integral part of their examination process, review our Company's allowance for loan losses. These agencies may require us to recognize changes to the allowance based on their evaluation of information available to them. We believe that the current allowance is adequate to offset any exposure that may exist for loans that are under secured or loans that might not be collectible.

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

Allocation of the Allowance for Loan Losses

The allocation of the allowance for loan losses is our determination of the amounts necessary for concentrations and changes in mix and volume of the loan portfolio. The unallocated portion of the allowance is based upon our assessment of general and specific economic conditions within our market. This allocation is more uncertain and considers risk factors that may not be reflected in our historical loss factors.

The following table shows the distribution of the allowance for loan losses and the percentage of loans compared to total loans by loan category (dollars in thousands):

	2006		2005		2004		2003		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Residential	**$ 614**	**49.7**	$ 493	51.1	$ 392	52.8	$ 368	56.8	$ 347	58.7
Commercial, agricultural	**1,676**	**26.8**	1,551	24.9	1,591	24.1	1,742	20.5	1,947	19.1
Construction	**-**	**1.7**	-	1.9	-	2.0	-	1.8	6	1.7
Loans to individuals for household, family and other purchases	**734**	**3.0**	542	3.4	463	3.5	492	4.1	471	4.7
Commercial and other loans	**582**	**7.9**	484	7.6	515	7.8	445	5.1	537	6.2
State & political subdivision loans	**22**	**10.9**	21	11.1	18	9.8	15	11.7	26	9.6
Unallocated	**248**	**N/A**	573	N/A	940	N/A	558	N/A	287	N/A
Total allowance for loan losses	**$ 3,876**	**100.0**	$ 3,664	100.0	$ 3,919	100.0	$ 3,620	100.0	$ 3,621	100.0

Bank Owned Life Insurance

In 2003 the Company purchased $7.0 million of bank owned life insurance to offset future employee benefit costs. The Bank is the sole beneficiary on the policies, and will provide the Bank with an asset that will generate earnings to partially offset the current costs of benefits, and eventually (at the death of the insured's) provide partial recovery of cash outflows associated with the benefits. As of December 31, 2006 and 2005, the cash surrender value of the life insurance was $8.0 and $7.7 million, respectively. The change in cash surrender value is recognized in the results of operations. The amounts recorded as non-interest income totaled $304,000, $294,000 and $307,000 in 2006, 2005 and 2004, respectively. The Company evaluates annually the risks associated with the life insurance policies, including limits on the amount of coverage and an evaluation of the various carriers' credit ratings.

Deposits

2006

As can be seen in the tables below, total deposits increased $16.7 million in 2006, or 3.9%. Non-interest bearing deposits decreased $2.1 million. As a percent to total, non-interest bearing deposits totaled 10.9% as of the end of 2006, which compares to 11.8% at the end of 2005. NOW accounts increased by $12.5 million, or 17.0% since the end of 2005. Most of the increase in NOW accounts is due to local governmental agencies moving their accounts from money market accounts to NOW accounts. As a consequence, money market deposit accounts decreased by $6.6 million in 2006, a decrease of 12.5%. The Company has focused on adding low cost deposits by having a free checking product available for retail customers, being one of the few banks within our market to pay interest on a senior checking product and developing larger deposit relationships with our commercial customers. We anticipate continuing our emphasis on obtaining low cost deposits in 2007, albeit within a competitive environment.

Certificates of deposit increased $13.5 million, or 6.3% from 2005 primarily due to $13.9 million of brokered certificates of deposit as of December 31, 2006. Due to the flattened yield curve, we have kept the maturities of brokered deposits between six and eighteen months.

In order to control our overall cost of funds, we continue to emphasize growing non-interest bearing or low cost deposits by deepening our relationships with existing customers. We continuously examine our portfolio of deposit products in order to meet the needs of customers and remain competitive in the market place.

2005

The Company experienced an increase in total deposits of $10.7 million in 2005, which represents a 2.6% increase. Most of this increase could be attributable to an increase in money market accounts of $10.3 million. This was accomplished by obtaining a large account from a local government agency. Non-interest-bearing deposits also increased $3.7 million, or 8.0%. Savings deposits decreased $1.3 million and certificates of deposit decreased $1.1 million.

The following table shows the breakdown of deposits by deposit type (dollars in thousands):

	2006		2005		2004	
	Amount	%	Amount	%	Amount	%
Non-interest-bearing deposits	**$ 48,509**	**10.9**	$ 50,600	11.8	$ 46,866	11.2
NOW accounts	**86,067**	**19.3**	73,548	17.1	74,446	17.7
Savings deposits	**37,637**	**8.4**	38,303	8.9	39,636	9.5
Money market deposit accounts	**46,066**	**10.3**	52,632	12.2	42,349	10.1
Certificates of deposit	**228,236**	**51.1**	214,716	50.0	215,777	51.5
Total	**$ 446,515**	**100.0**	$ 429,799	100.0	$ 419,074	100.0

	2006/2005 Change		2005/2004 Change	
	Amount	%	Amount	%
Non-interest-bearing deposits	**$ (2,091)**	**(4.1)**	$ 3,734	8.0
NOW accounts	**12,519**	**17.0**	(898)	(1.2)
Savings deposits	**(666)**	**(1.7)**	(1,333)	(3.4)
Money market deposit accounts	**(6,566)**	**(12.5)**	10,283	24.3
Certificates of deposit	**13,520**	**6.3**	(1,061)	(0.5)
Total	**$ 16,716**	**3.9**	$ 10,725	2.6

Remaining maturities of certificates of deposit of $100,000 or more are as follows (dollars in thousands):

	2006	2005	2004
3 months or less	**$ 8,714**	$ 8,743	$ 7,673
3 through 6 months	**14,697**	7,017	6,128
6 through 12 months	**16,604**	9,275	7,728
Over 12 months	**27,897**	30,859	30,190
Total	**$ 67,912**	$ 55,894	$ 51,719
As a percent of total certificates of deposit	**29.76%**	26.03%	23.97%

Deposits by type of depositor are as follows (dollars in thousands):

	2006		2005		2004	
	Amount	%	Amount	%	Amount	%
Individual, partnerships & corporations	**$ 386,314**	**86.5**	$ 371,057	86.3	$ 381,660	91.1
United States government	**1,591**	**0.4**	1,555	0.4	1,266	0.3
State & political subdivisions	**58,610**	**13.1**	57,187	13.3	36,148	8.6
Total	**$ 446,515**	**100.0**	$ 429,799	100.0	$ 419,074	100.0

Borrowed Funds

2006

Borrowed funds increased $23.1 million during 2006, an increase of 43.9%. This increase is primary due to an increase in short-term borrowings from the Federal Home Loan Bank (see Footnote 9 of the consolidated financial statements for additional information). This increase, along with the $16.7 million increase in deposits was used to fund growth in loans and investment securities of $31.8 and $7.1, respectively.

2005

Borrowed funds increased $17.7 million during the twelve months ending December 31, 2005 compared to the end of 2004, primarily due to an increase in short-term borrowings from the Federal Home Loan Bank (see Footnote 9 of the consolidated financial statements for additional information). Borrowings increased to fund the increase in loans and investment securities of $23.4 million and $6.9 million, respectively.

Stockholders' Equity

We evaluate stockholders' equity in relation to total assets and the risk associated with those assets. The greater the capital resources, the more likely a corporation is to meet its cash obligations and absorb unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance.

Our Board of Directors determines our dividend rate after considering our capital requirements, current and projected net income, and other factors. In 2006 and 2005, the Company paid out 42.1% and 44.3% of net income in dividends, respectively.

For the year ended December 31, 2006, the total number of common shares outstanding was 2,819,942. For comparative purposes, outstanding shares for prior periods were adjusted for the July, 2006 stock dividend in computing earnings and cash dividends per share as detailed in Footnote 1 of the consolidated financial statements. During 2006, we also purchased 54,239 shares of treasury stock at a weighted average cost of $22.53 per share.

There are currently three federal regulatory measures of capital adequacy. The Company's ratios meet the regulatory standards for well capitalized for 2006 and 2005, as detailed in Footnote 13 of the consolidated financial statements.

2006

Stockholders' equity increased 4.7% in 2006 to $43.5 million. Excluding accumulated other comprehensive income, which is essentially the after-tax effect of unrealized holding gains and losses on available-for-sale securities, and additional pension obligation, stockholders' equity increased $2.1 million, or 5.0%. This increase is due to net income of $5,800,000, offset by cash dividends of $2,442,000 and purchase of treasury stock of $1,222,000. Total equity was approximately 7.6% of total assets as of December 31, 2006, compared to 7.9% of total assets as of December 31, 2005.

2005

Stockholders' equity increased by 2.0% in 2005 to $41.6 million. Excluding accumulated other comprehensive income, stockholders' equity increased $2.5 million, or 6.1%. This increase was due to net income of $5,274,000 offset by cash dividends of $2,335,000 and purchase of treasury stock of $463,000.

LIQUIDITY

Liquidity is a measure of the Company's ability to efficiently meet normal cash flow requirements of both borrowers and depositors. Liquidity is needed to meet depositors' withdrawal demands, extend credit to meet borrowers' needs, provide funds for normal operating expenses and cash dividends, and fund future capital expenditures.

To maintain proper liquidity, we use funds management policies along with our investment policies to assure we can meet our financial obligations to depositors, credit customers and stockholders. Management monitors liquidity by reviewing loan demand, investment opportunities, deposit pricing and the cost and availability of borrowing funds. The Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows from investing and financing activities.

Cash generated by operating activities, investing activities and financing activities influences liquidity management. The most important source of funds is the deposits that are primarily core deposits (deposits from customers with other relationships). Short-term debt from the Federal Home Loan Bank supplements the Company's availability of funds as well as line of credit arrangements with corresponding banks totaling $13.0 million. Other sources of short-term funds include brokered CD's and the sale of loans, if needed.

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is detailed. Other significant uses of funds are capital expenditures, purchase of loans and acquisition premiums. Surplus funds are then invested in investment securities.

Capital expenditures in 2006 totaled $1,335,000, which included:

§ The construction of a de novo banking facility in Wellsville, New York totaling approximately $1.1 million.

§ The construction of a new and enlarged parking lot for our Sayre Lockhart facility totaling approximately $150,000.

§ Upgrades to data processing equipment totaling $45,000.

Capital expenditures were $1,306,000 in 2005, which included:

§ The purchase of additional property in Wellsboro for future expansion, and Wellsville, New York for the purpose of building a de novo banking facility totaling approximately $976,000.

§ Installation of new HVAC systems at several branch locations, totaling approximately $101,000.

§ Upgrades to ATM's in the amount of $48,000.

These expenditures will allow us to support our growth over the next decade, create greater operating efficiency and provide the customer with higher quality banking services.

The Company achieves additional liquidity primarily from temporary or short-term investments in the Federal Home Loan Bank of Pittsburgh, PA, investments that mature in less than one year and expected principal repayments from mortgage backed securities. The Company also has a maximum borrowing capacity at the Federal Home Loan Bank of approximately $227 million, inclusive of any outstanding amounts, as an additional source of liquidity.

Apart from those matters described above, management does not currently believe that there are any current trends, events or uncertainties that would have a material impact on capital.

INTEREST RATE AND MARKET RISK MANAGEMENT

The objective of interest rate sensitivity management is to maintain an appropriate balance between the stable growth of income and the risks associated with maximizing income through interest sensitivity imbalances and the market value risk of assets and liabilities.

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk and, since the Company has no trading portfolio, it is not subject to trading risk.

The primary factors that make assets interest-sensitive include adjustable-rate features on loans and investments, loan repayments and investment maturities. The primary components of interest-sensitive liabilities include maturing certificates of deposit, IRA certificates of deposit, repurchase agreements and short-term borrowings. Savings deposits, NOW accounts and money market investor accounts are considered core deposits and are not short-term interest sensitive (except for the top-tier money market investor and NOW accounts which are paid current market interest rates).

The following table shows the cumulative static gap (at amortized cost) for various time intervals (dollars in thousands):

Maturity or Repricing of Company Assets and Liabilities as of December 31, 2006

	Within Three Months	Four to Twelve Months	One to Two Years	Two to Three Years	Three to Five Years	Over Five Years	Total
Interest-earning assets:							
Interest-bearing deposits at banks	$ 8	$ -	$ -	$ -	$ -	$ -	$ 8
Investment securities	12,712	10,322	15,250	33,727	20,742	17,976	110,729
Residential mortgage loans	15,898	26,776	40,968	36,908	37,747	54,789	213,086
Commercial and farm loans	36,502	20,062	30,466	22,736	29,669	4,507	143,942
Loans to state & political subdivisions	498	13,173	14,315	5,384	2,374	9,519	45,263
Other loans	2,616	2,946	2,802	1,457	1,240	1,421	12,482
Total interest-earning assets	$ 68,234	$ 73,279	$ 103,801	$ 100,212	$ 91,772	$ 88,212	$ 525,510
Interest-bearing liabilities:							
NOW accounts	$ 38,760	$ -	$ -	$ -	$ -	$ 47,307	$ 86,067
Savings accounts	-	-	-	-	-	37,637	37,637
Money Market accounts	46,066	-	-	-	-	-	46,066
Certificates of deposit	31,097	88,866	51,671	22,815	32,815	972	228,236
Short-term borrowing	49,773	-	-	-	-	-	49,773
Long-term borrowing	10,500	2,085	11,287	2,000	130	-	26,002
Total interest-bearing liabilities	$ 176,196	$ 90,951	$ 62,958	$ 24,815	$ 32,945	$ 85,916	$ 473,781
Excess interest-earning assets (liabilities)	$ (107,962)	$ (17,672)	$ 40,843	$ 75,397	$ 58,827	$ 2,296	
Cumulative interest-earning assets	$ 68,234	$ 141,513	$ 245,314	$ 345,526	$ 437,298	$ 525,510	
Cumulative interest-bearing liabilities	176,196	267,147	330,105	354,920	387,865	473,781	
Cumulative gap	$ (107,962)	$ (125,634)	$ (84,791)	$ (9,394)	$ 49,433	$ 51,729	
Cumulative interest rate sensitivity ratio (1)	0.39	0.53	0.74	0.97	1.13	1.11	

(1) Cumulative interest-earning assets divided by interest-bearing liabilities.

The previous table and the simulation models discussed below are presented assuming money market investment accounts and NOW accounts in the top interest rate tier are repriced within the first three months. The loan amounts reflect the principal balances expected to be re-priced as a result of contractual amortization and anticipated early

payoffs.

Gap analysis, one of the methods used by us to analyze interest rate risk, does not necessarily show the precise impact of specific interest rate movements on the Company’s net interest income because the re-pricing of certain assets and liabilities is discretionary and is subject to competition and other pressures. In addition, assets and liabilities within the same period may, in fact, be repaid at different times and at different rate levels.

The Company currently uses a computer simulation model to better measure the impact of interest rate changes on net interest income. We use the model as part of our risk management process that will effectively identify, measure, and monitor the Company’s risk exposure. In this analysis, the Company examines the results of 100 and 200 basis point changes in market rates and the effect on tax equivalent net interest income. It is assumed that the change in interest rates is instantaneous and that all rates move in a parallel manner. Assumptions are also made concerning prepayment speeds on mortgage loans and mortgage securities. The following is a rate shock analysis for the period indicated (dollars in thousands):

Changes in Rates	Prospective One-Year Net Interest Income	Change In Prospective Net Interest Income	% Change In Prospective Net Interest Income
-200	$ 18,829	$ 1,219	6.96
-100	18,279	669	3.82
Base	17,610	-	-
+100	16,399	(1,211)	(6.91)
+200	15,082	(2,528)	(14.43)

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage backed securities, call activity of other investment securities, and deposit selection, re-pricing and maturity structure. Because of these assumptions, actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change on net interest income. Additionally, the changes above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change.

GENERAL

The majority of assets and liabilities of a financial institution are monetary in nature and, therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an important impact on the growth of total assets and on non-interest expenses, which tend to rise during periods of general inflation. The actions of the Federal Reserve of increasing short-term interest rates over the last two and a half years should help the level of inflation remain at a relatively low level. It has however provided significant challenges due to the continued, inverted/flattened yield curve and its impact on interest rate margins.

In 2006, legislation has been passed regarding changes to FDIC deposit insurance. This legislation increases coverage for retirement accounts from $100,000 to $250,000, merges the two existing deposit insurance funds and indexes the insurance level for inflation. The resulting premiums, although estimated, could result in significantly higher premiums than in the past, and/or could result in more volatility of the level of premiums charged to the Company.

Normal examinations of our Company are performed by the Office of Comptroller of the Currency. The last Community Reinvestment Act performance evaluation by the same agency resulted in a rating of “Outstanding Record of Meeting Community Credit Needs.”

Aside from those matters described in this annual report, we do not believe that there are any trends, events or uncertainties that would have a material adverse impact on future operating results, liquidity or capital resources. We are not aware of any current recommendations by the regulatory authorities which, if they were to be implemented, would have such an effect, although the general cost of compliance with numerous and multiple federal and state laws and regulations does have, and in the future may have, a negative impact on the Company’s results of operations.

CRITICAL ACCOUNTING POLICIES

The Company's accounting policies are integral to understanding the results reported. The accounting policies are described in detail in Note 1 of the consolidated financial statements. Our most complex accounting policies require management's judgment to ascertain the valuation of assets, liabilities, commitments and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

Other Than Temporary Impairment of Equity Securities

Equity securities are evaluated periodically to determine whether a decline in their value is other than temporary and is a matter of judgment. Management uses criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent. It indicates that the prospects for a near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

Allowance for Loan Losses

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. The Company's allowance for loan losses provides for probable losses based upon evaluations of known and inherent risks in the loan portfolio.

Management uses historical information to assess the adequacy of the allowance for loan losses as well as the prevailing business environment; as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. This evaluation is inherently subjective as it requires significant estimates that may be susceptible to significant change, subjecting the Bank to volatility of earnings. The allowance is increased by provisions for loan losses and by recoveries of loans previously charged-off and reduced by loans charged-off. For a full discussion of the Company's methodology of assessing the adequacy of the reserve for loan losses, refer to Note 1 of the consolidated financial statements.

Goodwill and Other Intangible Assets

As discussed in Note 1 of the consolidated financial statements, the Company must assess goodwill and other intangible assets each year for impairment. This assessment involves estimating cash flows for future periods. If the future cash flows were less than the recorded goodwill and other intangible assets balances, we would be required to take a charge against earnings to write down the assets to the lower value.

Deferred Tax Assets

We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future income should prove non-existent or less than the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced. Management also evaluates deferred tax assets to determine if it is more likely than not that the deferred tax benefit will be utilized in future periods. If not, a valuation allowance is recorded. Our deferred tax assets are described further in Note 11 of the consolidated financial statements.

CONTRACTUAL OBLIGATIONS, COMMITMENTS, AND OFF-BALANCE SHEET ARRANGEMENTS:
The Company has various financial obligations, including contractual obligations and commitments, which may require future cash payments.

Contractual Obligations:
The following table presents, as of December 31, 2006, significant contractual obligations to third parties by payment date. The payment amounts represent the principal amounts of certificates of deposit and borrowed funds, and do not include interest. Discussion of the obligations can be found in the notes to the consolidated financial statements (in thousands):

	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Certificates of Deposit	$ 119,963	$ 74,486	$ 32,815	$ 972	$ 228,236
Borrowed funds	54,858	20,787	130	-	75,775
Pension and other employee benefit obligations	931	277	409	1,272	2,889
Total	$ 175,752	$ 95,550	$ 33,354	$ 2,244	$ 306,900

Commitments:
The following table presents, as of December 31, 2006, the amounts and expected maturities of significant commitments. Discussion of these commitments and off-balance sheet arrangements can be found in the notes to the consolidated financial statements (in thousands):

	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Commitments to extend credit					
Commercial and agricultural real estate	$ 8,540	$ 3,482	$ 597	$ 6,359	$ 18,978
Residential real estate	1,641	-	391	13,012	15,044
Other commercial and consumer loans	5,922	2,182	1,183	16,547	25,834
Standby letters of credit	1,340	731	-	-	2,071
Total	$ 17,443	$ 6,395	$ 2,171	$ 35,918	$ 61,927

Commitments to extend credit, including loan commitments, standby letters of credit and commercial letters of credit do not necessarily represent future cash requirements, in that these commitments often expire without being drawn upon.

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FAX 570-724-4381
Marsha B. Jones, AVP
Deborah L. Meacham
Local Board
William A. Hebe, Esq., Chairman
D. Edward Cornell
Timothy J. Gooch, CPA
Marsha B. Jones
James K. Stager

LERAYSVILLE
1 Route 467 & Main Streets
LeRaysville, PA 18829
570-744-2431
FAX 570-744-2196
Debra A. Donnelly, AVP
Local Board
Louis C. Ugliuzza, Chairman
Debra A. Donnelly

Gary W. Horning
Suzanne S. Putnam
Betsy L. Seeley

Gerald A. Histand
Martha D. Young

ANNUAL MEETING

The Annual Meeting and Luncheon for the shareholders of Citizens Financial Services, Inc. will be held at Tioga County Fairgrounds Youth Building in Whitneyville, PA on Tuesday, April 17, 2007 at 12:00 noon.

FORM 10-K

The Annual Report to the Securities and Exchange Commission, Form 10-K, will be made available upon request.

CONTACT

Mickey L. Jones, Treasurer
Citizens Financial Services, Inc.
15 South Main Street
Mansfield, PA 16933

INVESTOR INFORMATION

Stock Listing:

Citizens Financial Services, Inc. common stock is listed on the over the counter bulletin board and is traded under the symbol CZFS.

For assistance regarding a change in registration of stock certificates, replacing lost certificates/dividend checks, or address changes, please contact the transfer agent listed below.

Transfer Agent:

Citizens Financial Services, Inc.
Attn: Gina Marie Boor
15 South Main Street
Mansfield, PA 16933
toll free: 1-800-326-9486
telephone: 570-662-2121
website: www.firstcitizensbank.com
e-mail: fcnb@firstcitizensbank.com

Dividend Reinvestment:

Citizens Financial Services, Inc. offers a Dividend Reinvestment Plan. Shareholders must enroll at least 100 shares to participate in the Plan. Cash dividends are held by our Plan Administrator and used to automatically purchase additional shares of our common stock. You may choose to have all dividends reinvested or a portion. Please contact the Transfer Agent listed for an enrollment form.

Certificate Safekeeping:

Stock certificates can be held by our Plan Administrator for safekeeping, commonly referred to as book entry shares. A dividend check is produced for book entry shares. Please contact the Transfer Agent listed for an enrollment form.

Direct Deposit of Dividends:

For shareholders who do not participate in the Dividend Reinvestment Plan, direct deposit of cash dividend payments to a checking or savings account is available. Please contact the Transfer Agent listed for an enrollment form.

Reports:

The Annual Report and other Company reports are filed electronically through the Electronic Data Gathering, Analysis, and Retrieval System (“EDGAR”) which performs automated collection, validation, indexing, acceptance, and forwarding of submissions to the Securities and Exchange Commission (SEC) and is accessible by the public using the internet at: http://www.sec.gov/edgar.htm.

MARKET MAKERS

Ferris, Baker Watts, Inc.	Automated Trading Desk	Knight Equity Markets, LP	Sandler O’Neill & Partners,
100 Light St., 9th Fl.	Financial Services	525 Washington Blvd.	LP

Baltimore, MD 21202
Telephone: 410-659-4600

Ryan, Beck & Co.
Head Trader
18 Columbia Turnpike
Florham Pk, NJ 07932
Telephone: 973-549-4200

UBS Securities, LLC
677 Washington Blvd, 6th Floor
Stamford, CT 06901-0305
Telephone: 203-719-7100

11 E Wall Street
Mt. Pleasant, SC 29464
843-789-2168

Boenning & Scattergood Inc.
200 Barr Harbor Dr. Ste. 300
4 Tower Bridge
W. Conshohocken, PA 19428
Telephone: 610-832-1212

Keefe, Bruyette & Woods, Inc.
787 Seventh Ave., 4th Fl.
New York, NY 10019
Telephone: 212-554-2600

Newport Tower, 30th Fl.
Jersey City, NJ 07310
Telephone: 201-222-9400

Hill Thompson Magid & Co.
15 Exchange Pl., 8th Fl.
Suite 800
Jersey City, NJ 07302
Telephone: 201-434-6900

Pershing Trading Company
One Pershing Plaza
Jersey City, NJ 07399
Telephone: 201-413-3531

919 Third Avenue, 6th Floor
New York, NY 10022
Telephone: 212-466-8023

Monroe Securities, Inc.
47 State St., 2nd Fl.
Rochester, NY 14614
Telephone: 800-766-5560

Cerniglia-Waggener Financial Group
Ryan Beck & Co.
7111 Fairway Dr., Suite 301
Palm Beach Gardens, FL 33418
Telephone: 866-780-7926