

CITIZENS FINANCIAL SERVICES INC
Form 10-Q
November 08, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012
Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-13222

CITIZENS FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

PENNSYLVANIA
(State or other jurisdiction of incorporation or organization)
No.)

23-2265045
(I.R.S. Employer Identification
No.)

15 South Main Street
Mansfield, Pennsylvania 16933
(Address of principal executive offices)(Zip Code)

Registrant's telephone number, including area code: (570) 662-2121

Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of outstanding shares of the Registrant's Common Stock, as of November 1, 2012, was 2,914,190.

Citizens Financial Services, Inc.
Form 10-Q

INDEX

| | PAGE | |
|----------|---|-------|
| Part I | FINANCIAL INFORMATION | |
| Item 1. | Financial Statements (unaudited): | |
| | Consolidated Balance Sheet as of September 30, 2012 and December 31, 2011 | 1 |
| | Consolidated Statement of Income for the Three Months and Nine Months Ended September 30, 2012 and 2011 | 2 |
| | Consolidated Statement of Comprehensive Income for the Three Months and Nine Months ended September 30, 2012 and 2011 | 3 |
| | Consolidated Statement of Cash Flows for the Nine Months ended September 30, 2012 and 2011 | 4 |
| | Notes to Consolidated Financial Statements | 5-26 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 27-50 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 50 |
| Item 4. | Controls and Procedures | 50 |
| Part II | OTHER INFORMATION | |
| Item 1. | Legal Proceedings | 51 |
| Item 1A. | Risk Factors | 51 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 51 |
| Item 3. | Defaults Upon Senior Securities | 51 |
| Item 4. | Mine Safety Disclosures | 51 |
| Item 5. | Other Information | 51 |
| Item 6. | Exhibits | 52 |
| | Signatures | 53 |

CITIZENS FINANCIAL SERVICES, INC.
CONSOLIDATED BALANCE SHEET
(UNAUDITED)

| (in thousands except share data) | September 30 2012 | December 31 2011 |
|--|----------------------|---------------------|
| ASSETS: | | |
| Cash and due from banks: | | |
| Noninterest-bearing | \$ 10,086 | \$ 9,960 |
| Interest-bearing | 624 | 20,472 |
| Total cash and cash equivalents | 10,710 | 30,432 |
| Available-for-sale securities | 322,039 | 318,823 |
| Loans (net of allowance for loan losses: 2012, \$6,734 and 2011, \$6,487) | 492,492 | 481,022 |
| Premises and equipment | 11,419 | 11,702 |
| Accrued interest receivable | 3,961 | 3,621 |
| Goodwill | 10,256 | 10,256 |
| Bank owned life insurance | 14,047 | 13,669 |
| Other assets | 11,293 | 9,042 |
| TOTAL ASSETS | \$ 876,217 | \$ 878,567 |
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest-bearing | \$ 84,767 | \$ 85,605 |
| Interest-bearing | 644,440 | 648,388 |
| Total deposits | 729,207 | 733,993 |
| Borrowed funds | 47,956 | 53,882 |
| Accrued interest payable | 1,213 | 1,512 |
| Other liabilities | 7,865 | 7,712 |
| TOTAL LIABILITIES | 786,241 | 797,099 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred Stock | | |
| \$1.00 par value; authorized 3,000,000 shares | | |
| September 30, 2012 and December 31, 2011; | | |
| none issued in 2012 or 2011 | | |
| | - | - |
| Common stock | | |
| Authorized 15,000,000 shares 2012 and 2011; | | |
| issued 3,161,324 shares at September 30, 2012 | | |
| and | | |
| 3,132,866 at December 31, 2011 | 3,161 | 3,133 |
| Additional paid-in capital | 16,474 | 15,313 |
| Retained earnings | 70,255 | 63,337 |
| Accumulated other comprehensive income | 5,990 | 4,949 |
| Treasury Stock, at cost, 247,134 shares at September 30, 2012, 230,203 shares | | |

| | | |
|----------------------------|------------|------------|
| at December 31, 2011 | (5,904) | (5,264) |
| TOTAL STOCKHOLDERS' EQUITY | 89,976 | 81,468 |
| TOTAL LIABILITIES AND | | |
| STOCKHOLDERS' EQUITY | \$ 876,217 | \$ 878,567 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

CITIZENS FINANCIAL
SERVICES, INC.
CONSOLIDATED
STATEMENT OF INCOME
(UNAUDITED)

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|--|------------------------------------|--------------|-----------------------------------|---------------|
| (in thousands, except per share data) | 2012 | 2011 | 2012 | 2011 |
| INTEREST INCOME: | | | | |
| Interest and fees on loans | \$ 7,448 | \$ 7,555 | \$ 22,352 | \$ 22,413 |
| Interest-bearing deposits with banks | 5 | 22 | 11 | 64 |
| Investment securities: | | | | |
| Taxable | 1,085 | 1,095 | 3,519 | 3,443 |
| Nontaxable | 919 | 931 | 2,793 | 2,688 |
| Dividends | 17 | 10 | 49 | 39 |
| TOTAL INTEREST INCOME | 9,474 | 9,613 | 28,724 | 28,647 |
| INTEREST EXPENSE: | | | | |
| Deposits | 1,486 | 1,969 | 4,707 | 6,103 |
| Borrowed funds | 373 | 437 | 1,179 | 1,325 |
| TOTAL INTEREST EXPENSE | 1,859 | 2,406 | 5,886 | 7,428 |
| NET INTEREST INCOME | 7,615 | 7,207 | 22,838 | 21,219 |
| Provision for loan losses | 105 | 150 | 315 | 525 |
| NET INTEREST INCOME AFTER | | | | |
| PROVISION FOR LOAN LOSSES | 7,510 | 7,057 | 22,523 | 20,694 |
| NON-INTEREST INCOME: | | | | |
| Service charges | 1,139 | 1,185 | 3,346 | 3,258 |
| Trust | 148 | 163 | 472 | 466 |
| Brokerage and insurance | 80 | 79 | 305 | 297 |
| Gains on loans sold | 102 | 36 | 287 | 111 |
| Investment securities gains, net | 240 | 117 | 561 | 351 |
| Earnings on bank owned life insurance | 128 | 126 | 378 | 371 |
| Other | 109 | 122 | 342 | 323 |
| TOTAL NON-INTEREST INCOME | 1,946 | 1,828 | 5,691 | 5,177 |
| NON-INTEREST EXPENSES: | | | | |
| Salaries and employee benefits | 2,705 | 2,527 | 8,126 | 7,560 |
| Occupancy | 304 | 295 | 928 | 1,014 |
| Furniture and equipment | 113 | 115 | 315 | 338 |
| Professional fees | 209 | 197 | 701 | 526 |
| FDIC insurance | 115 | 47 | 353 | 547 |
| Pennsylvania shares tax | 115 | 146 | 441 | 439 |
| Other | 1,398 | 1,171 | 3,488 | 3,496 |
| TOTAL NON-INTEREST EXPENSES | 4,959 | 4,498 | 14,352 | 13,920 |

| | | | | |
|---|----------|----------|-----------|----------|
| Income before provision for income taxes | 4,497 | 4,387 | 13,862 | 11,951 |
| Provision for income taxes | 1,033 | 1,009 | 3,196 | 2,596 |
| NET INCOME | \$ 3,464 | \$ 3,378 | \$ 10,666 | \$ 9,355 |

PER COMMON SHARE

DATA:

| | | | | |
|----------------------|----------|----------|----------|----------|
| Net Income - Basic | \$ 1.19 | \$ 1.15 | \$ 3.66 | \$ 3.18 |
| Net Income - Diluted | \$ 1.19 | \$ 1.15 | \$ 3.66 | \$ 3.18 |
| Cash Dividends Paid | \$ 0.300 | \$ 0.265 | \$ 0.895 | \$ 0.790 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

CITIZENS FINANCIAL
SERVICES, INC.
CONSOLIDATED
STATEMENT OF
COMPREHENSIVE
INCOME
(UNAUDITED)

| (in thousands) | Three Months Ended | | Nine Months Ended | |
|---|--------------------|----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Net income | \$ 3,464 | \$ 3,378 | \$ 10,666 | \$ 9,355 |
| Other comprehensive income: | | | | |
| Increase in unrealized gains on available for sale securities | 1,724 | 2,077 | 2,041 | 5,628 |
| Income tax effect related to unrealized gains on available for sale securities | (587) | (706) | (694) | (1,913) |
| Decrease (increase) in unrealized loss on interest rate swap | 32 | (7) | 97 | (6) |
| Income tax effect related to change in unrealized loss on interest rate swap | (11) | 2 | (33) | 2 |
| Less: Reclassification adjustment for gains included in net income | (240) | (117) | (561) | (351) |
| Income tax effect related to reclassification adjustment for gains included in net income | 82 | 40 | 191 | 119 |
| Other comprehensive income, net of tax | 1,000 | 1,289 | 1,041 | 3,479 |
| Comprehensive income | \$ 4,464 | \$ 4,667 | \$ 11,707 | \$ 12,834 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

CITIZENS FINANCIAL SERVICES,
INC.CONSOLIDATED STATEMENT OF
CASH FLOWS

(UNAUDITED)

Nine Months Ended
September 30,

(in thousands)

2012 2011

CASH FLOWS FROM OPERATING
ACTIVITIES:

| | | |
|---|-----------|-----------|
| Net income | \$ 10,666 | \$ 9,355 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 315 | 525 |
| Depreciation and amortization | 311 | 394 |
| Amortization and accretion of investment securities, net | 1,782 | 1,455 |
| Deferred income taxes | 213 | 260 |
| Investment securities gains, net | (561) | (351) |
| Earnings on bank owned life insurance | (378) | (371) |
| Originations of loans held for sale | (21,625) | (7,470) |
| Proceeds from sales of loans held for sale | 21,912 | 7,581 |
| Realized gains on loans sold | (287) | (111) |
| Increase in accrued interest receivable | (340) | (525) |
| Decrease in accrued interest payable | (299) | (240) |
| Other, net | (941) | 381 |
| Net cash provided by operating activities | 10,768 | 10,883 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Available-for-sale securities: | | |
| Proceeds from sales | 18,363 | 9,790 |
| Proceeds from maturity and principal repayments | 86,565 | 61,896 |
| Purchase of securities | (109,289) | (119,451) |
| Proceeds from redemption of regulatory stock | 646 | 312 |
| Purchase of regulatory stock | (1,405) | - |
| Net increase in loans | (11,736) | (5,746) |
| Purchase of premises and equipment | (179) | (101) |
| Purchase of land for potential future expansion | - | (542) |
| Proceeds from sale of premises and equipment | - | 590 |

| | | |
|---|------------------|------------------|
| Proceeds from sale of foreclosed assets held for sale | 650 | 372 |
| Net cash used in investing activities | (16,385) | (52,880) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net (decrease) increase in deposits | (4,786) | 38,834 |
| Proceeds from long-term borrowings | 32 | 3,013 |
| Repayments of long-term borrowings | (5,627) | (7,000) |
| Net (decrease) increase in short-term borrowed funds | (331) | 835 |
| Purchase of treasury and restricted stock | (782) | (796) |
| Dividends paid | (2,611) | (2,073) |
| Net cash (used) provided by financing activities | (14,105) | 32,813 |
| Net decrease in cash and cash equivalents | (19,722) | (9,184) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 30,432 | 43,995 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 10,710 | \$ 34,811 |

Supplemental Disclosures of Cash Flow Information:

| | | |
|---|----------|----------|
| Interest paid | \$ 6,185 | \$ 7,669 |
| Income taxes paid | \$ 3,395 | \$ 2,015 |
| Loans transferred to foreclosed property | \$ 123 | \$ 670 |
| Investments sold and not settled included in other assets | \$ 1,403 | \$ - |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

CITIZENS FINANCIAL SERVICES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 - Basis of Presentation

Citizens Financial Services, Inc., (individually and collectively with its direct and indirect subsidiaries, the “Company”) is a Pennsylvania corporation organized as the holding company of its wholly owned subsidiary, First Citizens Community Bank (the “Bank”), and the Bank’s subsidiary, First Citizens Insurance Agency, Inc. (“First Citizens Insurance”). On June 29, 2012, the Bank completed the conversion from a national bank into a Pennsylvania state-chartered bank and trust company and changed its name from First Citizens National Bank to First Citizens Community Bank.

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) and in conformity with U.S. generally accepted accounting principles. Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. 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. All material inter-company balances and transactions have been eliminated in consolidation.

In the opinion of management of the Company, the accompanying interim financial statements for the periods ended September 30, 2012 and 2011 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the period. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. The financial performance reported for the Company for the nine month period ended September 30, 2012 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

Note 2 - Earnings per Share

The following table sets forth the computation of earnings per share. Earnings per share calculations give retroactive effect to stock dividends declared by the Company.

| | Three months ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-------------|------------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| Basic earnings per share computation: | | | | |
| Net income applicable to common stock | \$3,464,000 | \$3,378,000 | \$10,666,000 | \$9,355,000 |
| Weighted average common shares outstanding | 2,908,435 | 2,945,616 | 2,915,615 | 2,945,197 |
| Earnings per share - basic | \$1.19 | \$1.15 | \$3.66 | \$3.18 |

Diluted earnings per share computation:

| | | | | |
|--|-------------|-------------|--------------|-------------|
| Net income applicable to common stock | \$3,464,000 | \$3,378,000 | \$10,666,000 | \$9,355,000 |
| Weighted average common shares outstanding for basic earnings per share | 2,908,435 | 2,945,616 | 2,915,615 | 2,945,197 |
| Add: Dilutive effects of restricted stock | 2,066 | - | 1,762 | - |
| Weighted average common shares outstanding for dilutive earnings per share | 2,910,501 | 2,945,616 | 2,917,377 | 2,945,197 |
| Earnings per share - dilutive | \$1.19 | \$1.15 | \$3.66 | \$3.18 |

Restricted stock grants that were anti-dilutive were excluded from net income per share calculations. For the three months ended September 30, 2012 and 2011, 0 and 7,443 shares, respectively, related to the restricted stock program were excluded from the diluted earnings per share calculations since they were anti-dilutive. For the nine months ended September 30, 2012 and 2011, 3,419 and 7,443 shares, respectively, related to the restricted stock program were excluded from the diluted earnings per share calculations since they were anti-dilutive.

Note 3 - Income Tax Expense

Income tax expense is less than the amount calculated using the statutory tax rate, primarily as a result of tax-exempt income earned from state and municipal securities and loans and investments in tax credits.

Note 4 – Investments

The amortized cost and fair value of investment securities at September 30, 2012 and December 31, 2011 were as follows (in thousands):

| | Amortized | Gross Unrealized | Gross Unrealized | Fair |
|---|------------|---------------------|---------------------|------------|
| September 30, 2012 | Cost | Gains | Losses | Value |
| Available-for-sale securities: | | | | |
| U.S. agency securities | \$ 146,660 | \$ 2,443 | \$ (6) | \$ 149,097 |
| Obligations of state and political subdivisions | 94,877 | 6,152 | (54) | 100,975 |
| Corporate obligations | 10,738 | 477 | - | 11,215 |
| Mortgage-backed securities in government sponsored entities | 57,357 | 2,140 | (118) | 59,379 |
| Equity securities in financial institutions | 911 | 473 | (11) | 1,373 |
| Total available-for-sale securities | \$ 310,543 | \$ 11,685 | \$ (189) | \$ 322,039 |

| | Amortized | Gross Unrealized | Gross Unrealized | Fair |
|--------------------------------|------------|---------------------|---------------------|------------|
| December 31, 2011 | Cost | Gains | Losses | Value |
| Available-for-sale securities: | | | | |
| U.S. Agency securities | \$ 166,534 | \$ 2,087 | \$ (21) | \$ 168,600 |

| | | | | |
|---|------------|-----------|------|------------|
| Obligations of state and political subdivisions | 96,556 | 4,996 | (5) | 101,547 |
| Corporate obligations | 8,263 | 197 | - | 8,460 |
| Mortgage-backed securities in government sponsored entities | 36,630 | 2,356 | (12) | 38,974 |
| Equity securities in financial institutions | 823 | 420 | (1) | 1,242 |
| Total available-for-sale securities | \$ 308,806 | \$ 10,056 | (39) | \$ 318,823 |

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at September 30, 2012 and December 31, 2011 (in thousands). As of September 30, 2012, the Company owned 13 securities whose fair value was less than their cost basis.

September

| 30, 2012 | Less than Twelve Months | | Twelve Months or Greater | | Total | |
|---|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Agency securities \$ | 4,994 | (6) | \$ - | \$ - | \$ 4,994 | (6) |
| Obligations of state and political subdivisions | 3,352 | (54) | - | - | 3,352 | (54) |
| Mortgage-backed securities in government sponsored entities | 6,755 | (118) | - | - | 6,755 | (118) |
| Equity securities in financial institutions | 39 | (11) | - | - | 39 | (11) |
| Total securities \$ | 15,140 | (189) | \$ - | \$ - | \$ 15,140 | (189) |

December

| 31, 2011 | Less than Twelve Months | | Twelve Months or Greater | | Total | |
|---|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Agency securities \$ | 10,018 | (21) | \$ - | \$ - | \$ 10,018 | (21) |
| Obligations of states and political subdivisions | 1,057 | (3) | 771 | (2) | 1,828 | (5) |
| Mortgage-backed securities in government sponsored entities | 3,164 | (12) | - | - | 3,164 | (12) |
| | 39 | (1) | - | - | 39 | (1) |

Equity
securities
in
financial
institutions

| | | | | | | |
|---------------|-----------|---------|--------|--------|-----------|------|
| Total | | | | | | |
| securities \$ | 14,278 \$ | (37) \$ | 771 \$ | (2) \$ | 15,049 \$ | (39) |

As of September 30, 2012, the Company's investment securities portfolio contained unrealized losses on 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, obligations of states and political subdivisions, mortgage backed securities in government sponsored entities and equity securities in financial institutions. For fixed maturity investments management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more-likely-than-not that it will not be required to sell the security, before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an impairment loss unless sufficient evidence is available that the decline is not other than temporary 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 other than 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 for the nine months ended September 30, 2012 and 2011 were \$18,363,000 and \$9,790,000, respectively. For the three months ended September 30, 2012 and 2011, there were sales of \$1,709,000 and \$1,969,000, respectively, of available-for-sale securities. The gross gains and losses were as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------|-------------------------------------|--------|------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Gross gains | \$ 240 | \$ 161 | \$ 561 | \$ 424 |
| Gross losses | - | (44) | - | (73) |
| Net gains | \$ 240 | \$ 117 | \$ 561 | \$ 351 |

Investment securities with an approximate carrying value of \$187.7 million and \$177.9 million at September 30, 2012 and December 31, 2011, respectively, were pledged to secure public funds and certain other deposits.

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 fair value of debt securities at September 30, 2012, by contractual maturity, are shown below (in thousands):

| | Amortized Cost | Fair Value |
|--|-------------------|------------|
| Available-for-sale debt securities: | | |
| Due in one year or less | \$ 13,859 | \$ 13,994 |
| Due after one year through five years | 79,805 | 81,870 |
| Due after five years through ten years | 58,504 | 59,913 |
| Due after ten years | 157,464 | 164,889 |
| Total | \$ 309,632 | \$ 320,666 |

Note 5 – Loans

The Company grants loans primarily to customers throughout North Central Pennsylvania and Southern New York. Although the Company had a diversified loan portfolio at September 30, 2012 and December 31, 2011, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions. The following table summarizes the primary segments of the loan portfolio and how those segments are analyzed within the allowance for loan losses as of September 30, 2012 and December 31, 2011 (in thousands):

| September 30, 2012 | Total Loans | Individually evaluated for impairment | Collectively evaluated for impairment |
|-----------------------------|-------------|---------------------------------------|---------------------------------------|
| Real estate loans: | | | |
| Residential | \$ 182,999 | \$ 408 | \$ 182,591 |
| Commercial and agricultural | 187,907 | 7,405 | 180,502 |

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| | | | |
|---|-------------------|-----------------|----------------|
| Construction | 12,131 | - | 12,131 |
| Consumer | 10,527 | - | 10,527 |
| Other commercial and agricultural loans | 46,654 | 337 | 46,317 |
| State and political subdivision loans | 59,008 | - | 59,008 |
| Total | 499,226 \$ | 8,150 \$ | 491,076 |
| Allowance for loan losses | 6,734 | | |
| Net loans | \$ 492,492 | | |

| December 31, 2011 | Total Loans | Individually evaluated for impairment | Collectively evaluated for impairment |
|--|-------------------|---|---|
| Real estate loans: | | | |
| Residential | \$ 184,034 | \$ 94 | \$ 183,940 |
| Commercial and agricultural | 185,050 | 8,270 | 176,780 |
| Construction | 8,481 | - | 8,481 |
| Consumer | 10,746 | - | 10,746 |
| Other commercial and agricultural loans | 44,299 | 517 | 43,782 |
| State and political subdivision loans | 54,899 | - | 54,899 |
| Total | 487,509 | 8,881 | 478,628 |
| Allowance for loan losses | 6,487 | | |
| Net loans | \$ 481,022 | | |

The segments of the Bank's loan portfolio are disaggregated into classes to a level that allows management to monitor risk and performance. Residential real estate mortgages consists primarily of 15 to 30 year first mortgages on residential real estate, while residential real estate home equities are consumer purpose installment loans or lines of credit secured by a mortgage which is often a second lien on residential real estate with terms of 15 years or less. Commercial real estate loans are business purpose loans secured by a mortgage on commercial real estate. Agricultural real estate loans are loans secured by a mortgage on real estate used in agriculture production. Construction real estate loans are loans secured by residential or commercial real estate used during the construction phase of residential and commercial projects. Consumer loans are typically unsecured or primarily secured by something other than real estate and overdraft lines of credit connected with customer deposit accounts. Other commercial loans are loans for commercial purposes primarily secured by non-real estate collateral. Other agricultural loans are loans for agricultural purposes primarily secured by non-real estate collateral. State and political subdivisions are loans for state and local municipalities for capital and operating expenses or tax free loans used to finance commercial development.

Management considers commercial loans, other agricultural loans, commercial real estate loans and agricultural real estate loans which are 90 days or more past due to be impaired. Management will also consider a loan impaired based on other factors it becomes aware of, including the customer's results of operations and cash flows. These loans are analyzed to determine if it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allocation of the allowance for loan losses or a charge-off to the allowance for loan losses.

The following table includes the recorded investment and unpaid principal balances for impaired financing receivables by class, with the associated allowance amount, if applicable (in thousands):

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| | Unpaid Principal | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---------------------------------------|------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|
| September 30, 2012 | Balance | Allowance | Allowance | Investment | Allowance | Investment | Recognized |
| Real estate loans: | | | | | | | |
| Residential mortgages | \$ 272 | \$ 116 | \$ 135 | \$ 251 | \$ 8 | \$ 139 | 2 |
| Home equity | 156 | 18 | 139 | 157 | 14 | 100 | 3 |
| Commercial | 8,840 | 5,218 | 2,187 | 7,405 | 501 | 7,891 | 74 |
| Agricultural | - | - | - | - | - | - | - |
| Construction | - | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - | - |
| Other commercial loans | | | | | | | |
| | 384 | 28 | 309 | 337 | 1 | 439 | - |
| Other agricultural loans | | | | | | | |
| | - | - | - | - | - | - | - |
| State and political subdivision loans | | | | | | | |
| | - | - | - | - | - | - | - |
| Total | \$ 9,652 | \$ 5,380 | \$ 2,770 | \$ 8,150 | \$ 524 | \$ 8,569 | 79 |

| | Unpaid Principal | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---------------------------------------|------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|
| December 31, 2011 | Balance | Allowance | Allowance | Investment | Allowance | Investment | Recognized |
| Real estate loans: | | | | | | | |
| Residential mortgages | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | - |
| Home equity | 94 | 36 | 58 | 94 | 13 | 36 | 1 |
| Commercial | 9,394 | 5,663 | 2,607 | 8,270 | 433 | 8,585 | 65 |
| Agricultural | - | - | - | - | - | 371 | 37 |
| Construction | - | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - | - |
| Other commercial loans | | | | | | | |
| | 574 | 30 | 487 | 517 | 48 | 501 | - |
| Other agricultural loans | | | | | | | |
| | - | - | - | - | - | 160 | 20 |
| State and political subdivision loans | | | | | | | |
| | - | - | - | - | - | - | - |

subdivision
loans

| | | | | | | | |
|-------|-----------|----------|----------|----------|--------|----------|-----|
| Total | \$ 10,062 | \$ 5,729 | \$ 3,152 | \$ 8,881 | \$ 494 | \$ 9,653 | 123 |
|-------|-----------|----------|----------|----------|--------|----------|-----|

Credit Quality Information

For commercial real estate, agricultural real estate, construction, other commercial, other agricultural and state and political subdivision loans, management uses a nine point internal risk rating system to monitor the credit quality. The first five categories are considered not criticized and are aggregated as “Pass” rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The definitions of each rating are defined below:

- Pass (Grades 1-5) – These loans are to customers with credit quality ranging from an acceptable to very high quality and are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.
- Special Mention (Grade 6) – This loan grade is in accordance with regulatory guidance and includes loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.
- Substandard (Grade 7) – This loan grade is in accordance with regulatory guidance and includes loans that have a well-defined weakness based on objective evidence and be characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- Doubtful (Grade 8) – This loan grade is in accordance with regulatory guidance and includes loans that have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

- Loss (Grade 9) – This loan grade is in accordance with regulatory guidance and includes loans that are considered uncollectible, or of such value that continuance as an asset is not warranted.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay loan as agreed, the Bank's loan rating process includes several layers of internal and external oversight. The Company's loan officers are responsible for the timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under the supervision of management. All commercial and agricultural loans are reviewed annually to ensure the appropriateness of the loan grade. In addition, the Bank engages an external consultant on at least an annual basis. The external consultant is engaged to 1) review a minimum of 60% of the dollar volume of the commercial loan portfolio on an annual basis, 2) review new loans originated in the last year, 3) review all relationships in aggregate over \$500,000, 4) review all aggregate loan relationships over \$100,000 which are over 90 days past due or classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate.

The following tables represent credit exposures by internally assigned grades as of September 30, 2012 and December 31, 2011 (in thousands):

| September 30, 2012 | Pass | Special Mention | Substandard | Doubtful | Loss | Ending Balance |
|--|------------|--------------------|-------------|----------|------|----------------|
| Real estate loans: | | | | | | |
| Commercial | \$ 144,097 | \$ 8,356 | \$ 17,080 | \$ 74 | \$ - | \$ 169,607 |
| Agricultural | 15,720 | 618 | 1,962 | - | - | 18,300 |
| Construction | 12,131 | - | - | - | - | 12,131 |
| Other commercial loans | 37,400 | 1,161 | 905 | 16 | - | 39,482 |
| Other agricultural loans | 6,046 | 270 | 856 | - | - | 7,172 |
| State and political subdivision loans | 57,900 | - | 1,108 | - | - | 59,008 |
| Total | \$ 273,294 | \$ 10,405 | \$ 21,911 | \$ 90 | \$ - | \$ 305,700 |

| December 31, 2011 | Pass | Special Mention | Substandard | Doubtful | Loss | Ending Balance |
|--------------------------------|------------|--------------------|-------------|----------|------|----------------|
| Real estate loans: | | | | | | |
| Commercial | \$ 138,409 | \$ 10,372 | \$ 17,045 | \$ - | \$ - | \$ 165,826 |
| Agricultural | 14,628 | 2,412 | 2,184 | - | - | 19,224 |
| Construction | 8,481 | - | - | - | - | 8,481 |
| Other commercial loans | 34,606 | 2,203 | 921 | 17 | - | 37,747 |
| Other agricultural loans | 4,509 | 809 | 1,234 | - | - | 6,552 |

State and
political
subdivision

| | | | | | | |
|-------|------------|-----------|-----------|-------|------|---------|
| loans | 53,733 | - | 1,166 | - | - | 54,899 |
| Total | \$ 254,366 | \$ 15,796 | \$ 22,550 | \$ 17 | \$ - | 292,729 |

For residential real estate mortgages, home equities and consumer loans, credit quality is monitored based on whether the loan is performing or non-performing, which is typically based on the aging status of the loan and payment activity, unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. Non-performing loans include those loans that are considered nonaccrual, described in more detail below and all loans past due 90 or more days. The following table presents the recorded investment in those loan classes based on payment activity as of September 30, 2012 and December 31, 2011 (in thousands):

| | | | |
|--------------------------|------------|----------------|------------|
| September 30, 2012 | Performing | Non-performing | Total |
| Real estate loans: | | | |
| Residential mortgages | \$ 108,031 | \$ 564 | \$ 108,595 |
| Home equity | 74,132 | 272 | 74,404 |
| Consumer | 10,525 | 2 | 10,527 |
| Total | \$ 192,688 | \$ 838 | \$ 193,526 |

| | | | |
|--------------------------|------------|----------------|------------|
| December 31, 2011 | Performing | Non-performing | Total |
| Real estate loans: | | | |
| Residential mortgages | \$ 102,238 | \$ 473 | \$ 102,711 |
| Home equity | 81,143 | 180 | 81,323 |
| Consumer | 10,746 | - | 10,746 |
| Total | \$ 194,127 | \$ 653 | \$ 194,780 |

Age Analysis of Past Due Financing Receivables

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table includes an aging analysis of the recorded investment of past due financing receivables as of September 30, 2012 and December 31, 2011 (in thousands):

| | 30-59 Days | 60-89 Days | 90 Days Or Greater | Total Past Due | Total Current | Total Financing Receivables | 90 Days and Accruing |
|------------------------------|---------------|---------------|-----------------------|-------------------|---------------|--------------------------------|-------------------------|
| September 30, 2012 | Past Due | Past Due | | | | | |
| Real estate loans: | | | | | | | |
| Residential mortgage | \$ 913 | \$ 3 | \$ 254 | \$ 1,170 | \$ 107,425 | \$ 108,595 | 78 |
| Home equity | 275 | 65 | 197 | 537 | 73,867 | 74,404 | 64 |
| Commercial | 336 | 129 | 2,193 | 2,658 | 166,949 | 169,607 | 295 |
| Agricultural | - | - | - | - | 18,300 | 18,300 | - |
| Construction | - | - | - | - | 12,131 | 12,131 | - |
| Consumer | 8 | 48 | 2 | 58 | 10,469 | 10,527 | 2 |
| Other commercial loans | | | | | | | |
| | 55 | 110 | 327 | 492 | 38,990 | 39,482 | - |
| Other agricultural | - | - | - | - | 7,172 | 7,172 | - |

| | | | | | | | |
|---------------------------------|----------|--------|----------|----------|------------|------------|--------|
| loans | | | | | | | |
| State and political subdivision | | | | | | | |
| loans | - | - | - | - | 59,008 | 59,008 | - |
| Total | \$ 1,587 | \$ 355 | \$ 2,973 | \$ 4,915 | \$ 494,311 | \$ 499,226 | \$ 439 |

| | | | | | | | |
|------------------------------|----------|--------|----------|----------|------------|------------|--|
| Loans considered non-accrual | \$ 171 | \$ 65 | \$ 2,534 | \$ 2,770 | \$ 5,485 | \$ 8,255 | |
| Loans still accruing | 1,416 | 290 | 439 | 2,145 | 488,826 | 490,971 | |
| Total | \$ 1,587 | \$ 355 | \$ 2,973 | \$ 4,915 | \$ 494,311 | \$ 499,226 | |

| | 30-59 Days | 60-89 Days | 90 Days Or Greater | Total Past Due | Current | Total Financing Receivables | 90 Days and Accruing |
|---|---------------|---------------|-----------------------|-------------------|------------|--------------------------------|-------------------------|
| December 31, 2011 | Past Due | Past Due | Or Greater | Due | | | |
| Real estate loans: | | | | | | | |
| Residential mortgages | \$ 428 | \$ 91 | \$ 398 | \$ 917 | \$ 101,794 | \$ 102,711 | \$ 60 |
| Home equity | 339 | - | 180 | 519 | 80,804 | 81,323 | 39 |
| Commercial | 319 | 412 | 2,794 | 3,525 | 162,301 | 165,826 | 176 |
| Agricultural | 143 | - | - | 143 | 19,081 | 19,224 | - |
| Construction | - | - | - | - | 8,481 | 8,481 | - |
| Consumer | 86 | 7 | - | 93 | 10,653 | 10,746 | - |
| Other commercial loans | 9 | - | 503 | 512 | 37,235 | 37,747 | - |
| Other agricultural loans | - | - | - | - | 6,552 | 6,552 | - |
| State and political subdivision loans | - | - | - | - | 54,899 | 54,899 | - |
| Total | \$ 1,324 | \$ 510 | \$ 3,875 | \$ 5,709 | \$ 481,800 | \$ 487,509 | \$ 275 |

| | | | | | | | |
|-------------------------------------|----------|--------|----------|----------|------------|------------|--|
| Loans considered non-accruing | \$ - | \$ - | \$ 3,600 | \$ 3,600 | \$ 5,565 | \$ 9,165 | |
| Loans still accruing | 1,324 | 510 | 275 | 2,109 | 476,235 | 478,344 | |
| Total | \$ 1,324 | \$ 510 | \$ 3,875 | \$ 5,709 | \$ 481,800 | \$ 487,509 | |

Nonaccrual Loans

Loans are considered for non-accrual status upon reaching 90 days delinquency, although the Company may be receiving partial payments of interest and partial repayments of principal on such loans or if full payment of principal and interest is not expected. Additionally, if management is made aware of other information including bankruptcy, repossession, death, or legal proceedings, the loan may be placed on non-accrual status. If a loan is 90 days or more past due and is well secured and in the process of collection, it may still be considered accruing.

The following table reflects the financing receivables on nonaccrual status as of September 30, 2012 and December 31, 2011, respectively. The balances are presented by class of financing receivable (in thousands):

September 30, 2012

December 31,
2011

Real estate

loans:

| | | | | |
|---------------------------------|----|-------|----|-------|
| Residential mortgages | \$ | 486 | \$ | 413 |
| Home equity | | 208 | | 141 |
| Commercial | | 7,224 | | 8,094 |
| Agricultural | | - | | - |
| Construction | | - | | - |
| Consumer | | - | | - |
| Other commercial loans | | 337 | | 517 |
| Other agricultural loans | | - | | - |
| State and political subdivision | | - | | - |
| | \$ | 8,255 | \$ | 9,165 |

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a Troubled Debt Restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to modify more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring by calculating the present value of the revised loan terms and comparing this balance to the Company's investment in the loan prior to the restructuring. As these loans are individually evaluated, they are excluded from pooled portfolios when calculating the allowance for loan and lease losses and a separate allocation within the allowance for loan and lease losses is provided. Management continually evaluates loans that are considered TDR's, including payment history under the modified loan terms, the borrower's ability to continue to repay the loan based on continued evaluation of their operating results and cash flows from operations. Based on this evaluation management would no longer consider a loan to be a TDR when the relevant facts support such a conclusion.

Loan modifications that are considered TDR's completed during the three months and nine months ended September 30, 2012 and 2011 were as follows (dollars in thousands):

For the Three Months Ended September 30, 2012

| | Number of contracts | | Pre-modification Outstanding Recorded Investment | | Post-Modification Outstanding Recorded Investment | | | | | |
|--------------------|---------------------|--------------|--|--------------|---|--------------|----|---|----|----|
| | Interest | Term | Interest | Term | Interest | Term | | | | |
| | Modification | Modification | Modification | Modification | Modification | Modification | | | | |
| Real estate loans: | | | | | | | | | | |
| Commercial | - | 1 | \$ | - | \$ | 62 | \$ | - | \$ | 62 |
| Total | - | 1 | \$ | - | \$ | 62 | \$ | - | \$ | 62 |

For the Nine months ended September 30, 2012

| | Number of contracts | | Pre-modification Outstanding Recorded Investment | | Post-Modification Outstanding Recorded Investment | | | | | | |
|----------------------|---------------------|--------------|--|--------------|---|--------------|-----|----|----|----|-----|
| | Interest | Term | Interest | Term | Interest | Term | | | | | |
| | Modification | Modification | Modification | Modification | Modification | Modification | | | | | |
| Real estate loans: | | | | | | | | | | | |
| Residential mortgage | 1 | | 1 | \$ | 48 | \$ | 71 | \$ | 48 | \$ | 71 |
| Commercial | | | | | | | | | | | |
| Commercial | | | | | | | | | | | |
| Commercial | | | | | | | | | | | |
| Total | 1 | | 4 | \$ | 48 | \$ | 231 | \$ | 48 | \$ | 231 |

For the Three Months Ended September 30, 2011

| | Number of contracts | | Pre-modification Outstanding Recorded Investment | | Post-Modification Outstanding Recorded Investment | | | | | |
|--------------------|---------------------|--------------|--|--------------|---|--------------|----|---|----|----|
| | Interest | Term | Interest | Term | Interest | Term | | | | |
| | Modification | Modification | Modification | Modification | Modification | Modification | | | | |
| Real estate loans: | | | | | | | | | | |
| Commercial | | | | | | | | | | |
| Commercial | | | | | | | | | | |
| Total | - | 1 | \$ | - | \$ | 47 | \$ | - | \$ | 47 |

For the Nine months ended September 30, 2011

| | Number of contracts | | Pre-modification Outstanding Recorded Investment | | Post-Modification Outstanding Recorded Investment | | | | | |
|--------------------|---------------------|--------------|--|--------------|---|--------------|----|-------|----|----|
| | Interest | Term | Interest | Term | Interest | Term | | | | |
| | Modification | Modification | Modification | Modification | Modification | Modification | | | | |
| Real estate loans: | | | | | | | | | | |
| Commercial | | | | | | | | | | |
| Commercial | | | | | | | | | | |
| Total | 5 | 1 | \$ | 5,912 | \$ | 47 | \$ | 5,912 | \$ | 47 |

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. Loan modifications considered TDR's made during the twelve months ended September 30, 2012, that defaulted during the three and nine month periods ended September 30, 2012 were as follows (dollars in thousands):

14

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| | For the Three Months Ended | | | | For the Nine Months Ended | | | |
|----------------------------|----------------------------|---------------------|---------------------|---------------------|---------------------------|---------------------|---------------------|---------------------|
| | September 30, 2012 | | September 30, 2011 | | September 30, 2012 | | September 30, 2011 | |
| | Number | Recorded investment | Number of contracts | Recorded investment | Number | Recorded investment | Number of contracts | Recorded investment |
| Real estate loans: | | | | | | | | |
| Commercial | - | \$ - | - | \$ - | 1 | \$ 50 | 2 | \$ 109 |
| Commercial and other loans | - | - | - | - | - | - | 1 | 2 |
| Total | - | \$ - | - | \$ - | 1 | \$ 50 | 3 | \$ 111 |

Allowance for Loan Losses

The following table segregates the allowance for loan losses (ALLL) into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of September 30, 2012 and December 31, 2011, respectively (in thousands):

| | September 30, 2012 | | | December 31, 2011 | | |
|---|---------------------------------------|---------------------------------------|----------|---------------------------------------|---------------------------------------|----------|
| | Individually evaluated for impairment | Collectively evaluated for impairment | Total | Individually evaluated for impairment | Collectively evaluated for impairment | Total |
| Real estate loans: | | | | | | |
| Residential | \$ 22 | \$ 843 | \$ 865 | \$ 13 | \$ 792 | \$ 805 |
| Commercial and agricultural | 501 | 3,730 | 4,231 | 433 | 3,699 | 4,132 |
| Construction | - | 26 | 26 | - | 15 | 15 |
| Consumer | - | 104 | 104 | - | 111 | 111 |
| Other commercial and agricultural loans | 1 | 665 | 666 | 48 | 626 | 674 |
| State and political subdivision loans | - | 274 | 274 | - | 235 | 235 |
| Unallocated | - | 568 | 568 | - | 515 | 515 |
| Total | \$ 524 | \$ 6,210 | \$ 6,734 | \$ 494 | \$ 5,993 | \$ 6,487 |

The following tables roll forward the balance of the ALLL by portfolio segment for the three and nine month periods ended September 30, 2012 and 2011, respectively (in thousands):

| | Balance at June 30, 2012 | | | | Charge-offs | Recoveries | Provision | Balance at September 30, 2012 | | |
|--|-----------------------------|--------------|-----------|-------------|-------------|------------|-----------|-------------------------------------|-----------|--------------|
| Real estate loans: | | | | | | | | | | |
| Residential | \$ | 786 | \$ | - | \$ | - | \$ | 79 | \$ | 865 |
| Commercial and agricultural | | 4,405 | | - | | 1 | | (175) | | 4,231 |
| Construction | | 19 | | - | | - | | 7 | | 26 |
| Consumer | | 108 | | (12) | | 9 | | (1) | | 104 |
| Other commercial and agricultural loans | | 685 | | (20) | | 1 | | - | | 666 |
| State and political subdivision loans | | 246 | | - | | - | | 28 | | 274 |
| Unallocated | | 401 | | - | | - | | 167 | | 568 |
| Total | \$ | 6,650 | \$ | (32) | \$ | 11 | \$ | 105 | \$ | 6,734 |

| | Balance at December 31, 2011 | | | | Charge-offs | Recoveries | Provision | Balance at September 30, 2012 | | |
|--|------------------------------------|--------------|-----------|--------------|-------------|------------|-----------|-------------------------------------|-----------|--------------|
| Real estate loans: | | | | | | | | | | |
| Residential | \$ | 805 | \$ | (49) | \$ | - | \$ | 109 | \$ | 865 |
| Commercial and agricultural | | 4,132 | | (2) | | 7 | | 94 | | 4,231 |
| Construction | | 15 | | - | | - | | 11 | | 26 |
| Consumer | | 111 | | (36) | | 25 | | 4 | | 104 |
| Other commercial and agricultural loans | | 674 | | (20) | | 7 | | 5 | | 666 |
| State and political subdivision loans | | 235 | | - | | - | | 39 | | 274 |
| Unallocated | | 515 | | - | | - | | 53 | | 568 |
| Total | \$ | 6,487 | \$ | (107) | \$ | 39 | \$ | 315 | \$ | 6,734 |

| | Balance at June 30, 2011 | | | | Charge-offs | Recoveries | Provision | Balance at September 30, 2011 | | |
|--|-----------------------------|--------------|-----------|-------------|-------------|------------|-----------|-------------------------------------|-----------|--------------|
| Real estate loans: | | | | | | | | | | |
| Residential | \$ | 678 | \$ | - | \$ | - | \$ | 147 | \$ | 825 |
| Commercial and agricultural | | 3,912 | | - | | - | | 250 | | 4,162 |
| Construction | | 13 | | - | | - | | 1 | | 14 |
| Consumer | | 109 | | (23) | | 16 | | 12 | | 114 |
| Other commercial and agricultural loans | | 712 | | (6) | | 23 | | (40) | | 689 |
| State and political subdivision loans | | 119 | | - | | - | | 1 | | 120 |
| Unallocated | | 620 | | - | | - | | (221) | | 399 |
| Total | \$ | 6,163 | \$ | (29) | \$ | 39 | \$ | 150 | \$ | 6,323 |

| | Balance at December 31, 2010 | Charge-offs | Recoveries | Provision | Balance at September 30, 2011 |
|--|------------------------------------|-------------|------------|-----------|-------------------------------------|
| Real estate loans: | | | | | |
| Residential | \$ 969 | \$ (101) | \$ - | \$ (43) | \$ 825 |
| Commercial and agricultural | 3,380 | (29) | - | 811 | 4,162 |
| Construction | 22 | - | - | (8) | 14 |
| Consumer | 108 | (56) | 45 | 17 | 114 |
| Other commercial and agricultural loans | 983 | (6) | 30 | (318) | 689 |
| State and political subdivision loans | 137 | - | - | (17) | 120 |
| Unallocated | 316 | - | - | 83 | 399 |
| Total | \$ 5,915 | \$ (192) | \$ 75 | \$ 525 | \$ 6,323 |

The Company allocates the ALLL based on the factors described below, which conform to the Company's loan classification policy and credit quality measurements. In reviewing risk within the Bank's loan portfolio, management has determined there to be several different risk categories within the loan portfolio. The ALLL consists of amounts applicable to: (i) residential real estate loans; (ii) residential real estate home equity loans; (iii) commercial real estate loans; (iv) agricultural real estate loans; (v) real estate construction loans; (vi) commercial and other loans; (vii) consumer loans; (viii) other agricultural loans and (ix) state and political subdivision loans. Factors considered in this process include general loan terms, collateral, and availability of historical data to support the analysis. Historical loss percentages are calculated and used as the basis for calculating allowance allocations. Certain qualitative factors are evaluated to determine additional inherent risks in the loan portfolio, which are not necessarily reflected in the historical loss percentages. These factors are then added to the historical allocation percentage to get the adjusted factor to be applied to non classified loans. The following qualitative factors are analyzed:

- Level of and trends in delinquencies, impaired/classified loans
 - Change in volume and severity of past due loans
 - Volume of non-accrual loans
 - Volume and severity of classified, adversely or graded loans;
 - Level of and trends in charge-offs and recoveries;
 - Trends in volume, terms and nature of the loan portfolio;
- Effects of any changes in risk selection and underwriting standards and any other changes in lending and recovery policies, procedures and practices;
 - Changes in the quality of the Bank's loan review system;
 - Experience, ability and depth of lending management and other relevant staff;
 - National, state, regional and local economic trends and business conditions
 - General economic conditions
 - Unemployment rates
 - Inflation / Consumer Price Index
 - Changes in values of underlying collateral for collateral-dependent loans;
- Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses; and
 - Existence and effect of any credit concentrations, and changes in the level of such concentrations.

The Company also maintains an unallocated allowance to account for any factors or conditions that may cause a potential loss but are not specifically addressed in the process described above. The Company analyzes its loan portfolio each quarter to determine the appropriateness of its allowance for loan losses.

Loans determined to be TDR's are impaired and for purposes of estimating the ALLL must be individually evaluated for impairment. In calculating the impairment, the Company calculates the present value utilizing an analysis of discounted cash flows. If the present value calculated is below the recorded investment of the loan, impairment is recognized by a charge to the provision for loan and lease losses and a credit to the ALLL.

We continually review the model utilized in calculating the required allowance. During the second quarter of 2011, management made a determination that special mention and substandard loans should have additional qualitative adjustments applied to them in comparison to pass graded loans. The following factors experienced changes during the first nine months of 2012:

- The qualitative factor for changes in values of underlying collateral was decreased for residential and commercial real estate loans due to the fact that the impact from the serious flooding experienced in our primary market in the third quarter of 2011 was not as severe as originally expected.
- The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were increased for residential real estate due to the increase in the Company's internal watch list for residential real estate loans

since December 31, 2011.

- The qualitative factors for changes in industry conditions were increased for agricultural real estate and other agricultural loans due to decreases in milk prices and higher feed costs from December 31, 2011 to September 30, 2012.
- The qualitative factor for national, state, regional and local economic trends and business conditions was increased for all loan categories due to rising unemployment rates in the local economy as a result of the slowdown in the development of the Marcellus gas play.
- The qualitative factor for changes in the quality of the Bank's loan review system was increased due to personnel changes.

The following factors experienced changes during the three months ended September 30, 2012:

- The qualitative factor for national, state, regional and local economic trends and business conditions was increased for all loan categories due to rising unemployment rates in the local economy as a result of the slowdown in the development of the Marcellus gas play.
- The qualitative factor for changes in the quality of the Bank's loan review system was increased due to personnel changes.
- The qualitative factor for level of and trends in delinquencies, impaired/classified loans was decreased for commercial real estate loans due to the decrease in outstanding loans as of September 30, 2012 that were classified as substandard or special mention in comparison to balances as of June 30, 2012.

The primary factor that resulted in a negative provision for the 2012 third quarter for commercial and agricultural loans was the overall decrease in commercial and agricultural loans from June to September and more specifically the decrease in special mention and substandard loans from June to September.

Note 6 – Federal Home Loan Bank Stock

The Bank is a member of the FHLB of Pittsburgh and as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. As of September 30, 2012 and December 31, 2011, the Bank held \$3,785,900 and \$3,027,000, respectively. The stock is bought from and sold to the FHLB based upon its \$100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated for by management. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) The significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) Commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) The impact of legislative and regulatory changes on the customer base of the FHLB and (d) The liquidity position of the FHLB.

The FHLB has incurred a significant cumulative loss in regards to comprehensive income in the three years ended December 31, 2011 and had suspended the payment of dividends; however, due to improved results in 2011 and 2010 over 2009, a dividend was paid in the first three quarters of 2012. The cumulative losses were primarily attributable to impairment of investment securities associated with the distressed economic conditions during 2008 and 2009. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB's regulatory capital ratios have improved in the most recent quarters, liquidity appears adequate, new shares of FHLB stock continue to exchange hands at the \$100 par value and the FHLB has repurchased shares of excess capital stock from its members through the third quarter of 2012 and has reinstated the dividend in 2012.

Note 7 - Employee Benefit Plans

For additional detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 11 of the Company's Consolidated Financial Statements included in the 2011 Annual Report on Form 10-K.

Noncontributory Defined Benefit Pension Plan

The Bank sponsors a noncontributory defined benefit pension plan ("Pension Plan") covering substantially all employees and officers. The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plan's actuary.

Any employee with a hire date of January 1, 2007 or later is not eligible to participate in the Pension Plan. In lieu of the Pension Plan, employees with a hire date of January 1, 2007 or later are eligible to receive, after meeting certain length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

For employees who are eligible to participate in the Pension Plan, the Pension Plan requires benefits to be paid to eligible employees based primarily upon age and compensation rates during employment. Upon retirement or other termination of employment, employees can elect either an annuity benefit or a lump sum distribution of vested benefits in the Pension Plan.

The following sets forth the components of net periodic benefit costs of the Pension Plan for the three and nine months ended September 30, 2012 and 2011, respectively (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------|-------------------------------------|-------|------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Service cost | \$ 82 | \$ 71 | \$ 249 | \$ 256 |
| Interest cost | 85 | 88 | 259 | 314 |
| Expected return on plan assets | (139) | (129) | (425) | (465) |
| Net amortization and deferral | 34 | 10 | 102 | 36 |
| Net periodic benefit cost | \$ 62 | \$ 40 | \$ 185 | \$ 141 |

The Company contributed \$750,000 to the Pension Plan in 2012.

Defined Contribution Plan

The Company sponsors a voluntary 401(k) savings plan which eligible employees can elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). Under the plan, the Company also makes required contributions on behalf of the eligible employees. The Company's contributions vest immediately. Contributions by the Company totaled \$184,000 and \$171,000 for the nine months ended September 30, 2012 and 2011, respectively. For the three months ended September 30, 2012 and 2011, contributions by the Company totaled \$52,000 and \$47,000, 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. At September 30, 2012 and December 31, 2011, an obligation of \$999,000 and \$1,030,000, respectively, was included in other liabilities for this plan in the consolidated balance sheet. Amounts included in interest expense on the deferred amounts totaled \$12,000 and \$17,000 for the nine months ended September 30, 2012 and 2011, respectively.

Restricted Stock Plan

The Company maintains a Restricted Stock Plan (the “Plan”) whereby 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. A total of 100,000 shares of the Company’s common stock have been authorized under the Plan. The Plan assists the Company in attracting, retaining and motivating employees 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.

For the nine months ended September 30, 2012 and 2011, 3,808 and 3,968 shares of restricted stock were awarded and 5,222 and 5,502 shares vested, respectively. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. Compensation expense related to restricted stock was \$103,000 and \$109,000 for the nine months ended September 30, 2012 and 2011, respectively. For the three months ended September 30, 2012 and 2011, compensation expense totaled \$37,000 and \$36,000, respectively.

Supplemental Executive Retirement Plan

The Company maintains a non-qualified supplemental executive retirement plan (“SERP”) for certain executives to compensate those executive participants in the Company’s noncontributory defined benefit pension plan whose benefits are limited by compensation limitations under current tax law. At September 30, 2012 and December 31, 2011, an obligation of \$878,000 and \$809,000, respectively, was included in other liabilities for this plan in the consolidated balance sheet. Expenses related to this plan totaled \$69,000 and \$46,000 for the nine months ended September 30, 2012 and 2011, respectively. For the three months ended September 30, 2012 and 2011, expenses totaled \$23,000 and \$15,000, respectively.

Note 8 – Fair Value Measurements

The Company established a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by this hierarchy are as follows:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management’s best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, the company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. Our valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company’s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company’s monthly and/or quarterly valuation process.

Financial Instruments Recorded at Fair Value on a Recurring Basis

The fair values of securities available for sale are determined by quoted prices in active markets, when available, and classified as Level I. If quoted market prices are not available, the fair value is determined by a matrix pricing, which is a mathematical technique, widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities and classified as Level II. The fair values consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. In cases where significant credit valuation adjustments are incorporated into the estimation of fair value, reported amounts are classified as Level III inputs.

Currently, we use an interest rate swap, which is a derivative, to manage our interest rate risk related to the trust preferred security. The valuation of this instrument is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative and classified as Level II. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including LIBOR rate curves. We also obtain dealer quotations for these derivatives for comparative purposes to assess the reasonableness of the model valuations.

The following tables present the assets and liabilities reported on the consolidated balance sheet at their fair value on a recurring basis as of September 30, 2012 and December 31, 2011 by level within the fair value hierarchy (in thousands). Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| | September 30, 2012 | | | Total |
|---|--------------------|------------|-----------|------------|
| | Level I | Level II | Level III | |
| Fair value measurements on a recurring basis: | | | | |
| Assets | | | | |
| Securities available for sale: | | | | |
| U.S. Agency securities | \$ - | \$ 149,097 | \$ - | \$ 149,097 |
| Obligations of state and political subdivisions | - | 100,975 | - | 100,975 |
| Corporate obligations | - | 11,215 | - | 11,215 |
| Mortgage-backed securities in government sponsored entities | - | 59,379 | - | 59,379 |
| Equity securities in financial institutions | 1,373 | - | - | 1,373 |
| Liabilities | | | | |
| Trust Preferred Interest Rate Swap | - | (251) | - | (251) |

| | December 31, 2011 | | | Total |
|---|-------------------|------------|-----------|------------|
| | Level I | Level II | Level III | |
| Fair value measurements on a recurring basis: | | | | |
| Assets | | | | |
| Securities available for sale: | | | | |
| U.S. Agency securities | \$ - | \$ 168,600 | \$ - | \$ 168,600 |

| | | | | |
|---------------------------------------|-------|---------|---|---------|
| Obligations of state and | | | | |
| political subdivisions | - | 101,547 | - | 101,547 |
| Corporate obligations | - | 8,460 | - | 8,460 |
| Mortgage-backed securities in | | | | |
| government sponsored entities | - | 38,974 | - | 38,974 |
| Equity securities in financial | | | | |
| institutions | 1,242 | - | - | 1,242 |
| Liabilities | | | | |
| Trust Preferred Interest Rate Swap | - | (348) | - | (348) |

Financial Instruments Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain financial assets and financial liabilities at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market value that were recognized at fair value below cost at the end of the period.

Impaired Loans- Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. For those loans valued utilizing collateral value or liquidation value consideration is given to the time since an appraisal was performed, selling costs including legal fees and the length of time it will take to sell the collateral. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Collateral values are estimated using Level II inputs based on observable market data or Level III inputs based on customized discounting criteria. For a majority of impaired real estate related loans, the Company obtains a current external appraisal. Other valuation techniques are used as well, including internal valuations, comparable property analysis and contractual sales information.

Non-Financial Assets and Non-Financial Liabilities Recorded at Fair Value

The Corporation has no non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Certain non-financial assets measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. Non-financial assets measured at fair value on a non-recurring basis during 2012 and 2011 include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for possible loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense. The fair value of a foreclosed asset is estimated using Level III inputs based on customized discounting criteria. The criteria utilized includes an external appraisal, length of time since the appraisal was obtained, selling costs including legal fees and the length of time it will take to sell the collateral.

Assets measured at fair value on a nonrecurring basis as of September 30, 2012 and December 31, 2011 are included in the table below (in thousands):

| | September 30, 2012 | | | Total |
|-------------------------|--------------------|----------|-----------|----------|
| | Level 1 | Level II | Level III | |
| Impaired Loans | \$ - | \$ - | 7,626 | \$ 7,626 |
| Other real estate owned | - | - | 463 | 463 |
| | | | | |
| | December 31, 2011 | | | Total |
| | Level 1 | Level II | Level III | |
| Impaired Loans | \$ - | \$ - | 8,387 | \$ 8,387 |
| Other real estate owned | - | - | 860 | 860 |

The following table provides a listing of the significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques.

Quantitative Information about Level III Fair Value Measurements

| | Fair Value at September 30, 2012 | Valuation Technique(s) | Unobservable input | Range |
|----------------------------|---|--------------------------------|--------------------------------------|------------------|
| Impaired Loans | \$ 5,143 | Discounted Cash Flows | Probability of Default | 0% |
| | | | Change in interest rates | 0-7% |
| | 2,483 | Appraised Collateral Values | Discount for time since appraisal | 0-20% |
| | | | Selling costs | 0%-10% |
| | | | Holding period | 0 - 18 months |
| Other real estate owned | 463 | Appraised Collateral Values | Discount for time since appraisal | 0-20% |
| | | | Selling costs | 6%-10% |
| | | | Holding period | 0 - 18 months |

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

| September 30, 2012 | Carrying Amount | Fair Value | Level I | Level II | Level III | Total |
|---------------------------------------|--------------------|------------|------------|----------|------------|------------|
| Financial assets: | | | | | | |
| Cash and due from banks | \$ 10,710 | \$ 10,710 | \$ 10,710 | \$ - | \$ - | \$ 10,710 |
| Available-for-sale securities | 322,039 | 322,039 | 1,373 | 320,666 | - | 322,039 |
| Net loans | 492,492 | 543,094 | - | - | 543,094 | 543,094 |
| Bank owned life insurance | 14,047 | 14,047 | 14,047 | - | - | 14,047 |
| Regulatory stock | 4,060 | 4,060 | 4,060 | - | - | 4,060 |
| Accrued interest receivable | 3,961 | 3,961 | 3,961 | - | - | 3,961 |
| Financial liabilities: | | | | | | |
| Deposits | \$ 729,207 | \$ 735,251 | \$ 443,101 | \$ - | \$ 292,150 | \$ 735,251 |
| Borrowed funds | 47,956 | 45,040 | - | 45,040 | - | 45,040 |
| Trust preferred interest rate swap | 251 | 251 | - | 251 | - | 251 |
| Accrued interest payable | 1,213 | 1,213 | 1,213 | - | - | 1,213 |

| December 31, 2011 | Carrying Amount | Fair Value |
|-------------------|--------------------|------------|
| Financial assets: | | |

| | | |
|------------------------------------|------------|------------|
| Cash and cash equivalents | \$ 30,432 | \$ 30,432 |
| Available-for-sale securities | 318,823 | 318,823 |
| Net loans | 481,022 | 527,724 |
| Bank owned life insurance | 13,669 | 13,669 |
| Regulatory stock | 3,301 | 3,301 |
| Accrued interest receivable | 3,621 | 3,621 |
| Financial liabilities: | | |
| Deposits | \$ 733,993 | \$ 740,839 |
| Borrowed funds | 53,882 | 51,437 |
| Trust preferred interest rate swap | 348 | 348 |
| Accrued interest payable | 1,512 | 1,512 |

Fair value is determined, 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.

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 have original maturities of 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.

Trust Preferred Interest Rate Swap:

The fair value of the trust preferred interest rate swap is based on a pricing model that utilizes a yield curve and information contained in the swap agreement.

Note 9 – Recent Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The Company has provided the necessary disclosures in Note 8.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. The amendments in this Update improve the comparability, clarity, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. All entities that report items of comprehensive income, in any period presented, will be affected by the changes in this Update. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The amendments in this Update should be applied retrospectively, and early adoption is permitted. The Company has provided the necessary disclosure in the Consolidated Statement of Comprehensive Income.

In September 2011, the FASB issued ASU 2011-08, Intangibles – Goodwill and Other Topics (Topic 350), Testing Goodwill for Impairment. The objective of this update is to simplify how entities, both public and nonpublic, test goodwill for impairment. The amendments in the Update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this Update, an entity is not required to calculate the fair value of a reporting unit unless the entity

determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this Update apply to all entities, both public and nonpublic, that have goodwill reported in their financial statements and are effective for interim and annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. This ASU did not have a significant impact on the Company's financial statements.

In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. The amendments in this Update affect all entities that have financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement. The requirements amend the disclosure requirements on offsetting in Section 210-20-50. This information will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on an entity's financial position, including the effect or potential effect of rights of setoff associated with certain financial instruments and derivative instruments in the scope of this Update. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. In order to defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in this Update supersede certain pending paragraphs in Update 2011-05. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before Update 2011-05. All other requirements in Update 2011-05 are not affected by this Update, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities should begin applying these requirements for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The Company has provided the necessary disclosure in the Consolidated Statement of Comprehensive Income.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

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 Community Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use words such 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. The Company would like to caution readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement:

- 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 not be able 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, regulations or requirements, including the costs of compliance with such changes.
- 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.
- Exploration and drilling of the natural gas reserves in the Marcellus Shale in our market area may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection, which could negatively impact our customers and, as a result, negatively impact our loan and deposit volume and loan quality.
- Similarly, customers dependent on the exploration and drilling of the natural gas reserves may be dependent on the market price of natural gas. As a result, decreases in the market price of natural gas could also negatively impact our customers.

Additional factors that may affect our results are discussed under “Part II – Item 1A – Risk Factors” in this report and in the Company's 2011 Annual Report on Form 10-K under “Item 1.A/ Risk Factors.” 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 the accompanying consolidated financial statements for the Company. Our

Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results you may expect for the full year.

The 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 main office in Mansfield, Pennsylvania. Presently we operate 19 banking facilities, 17 of which operate as bank branches. In Pennsylvania, we have branch offices located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Wellsboro Weis Market store and the Mansfield Wal-Mart Super Center. We also have a loan production office in Lock Haven, Pennsylvania. In New York, we have a branch office in Wellsville, Allegany County.

Risk Management

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, reputational 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.

Reputational risk, or the risk to our business, earnings, liquidity, and capital from negative public opinion, could result from our actual or alleged conduct in a variety of areas, including legal and regulatory compliance, lending practices, corporate governance, litigation, ethical issues, or inadequate protection of customer information. We expend significant resources to comply with regulatory requirements. Failure to comply could result in reputational harm or significant legal or remedial costs. Damage to our reputation could adversely affect our ability to retain and attract new customers, and adversely impact our earnings and liquidity.

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 cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.

Competition

The banking industry in the Bank's service area continues to be extremely competitive, both among commercial banks and with financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions and internet entities. The increased competition has resulted from changes in the legal and regulatory guidelines as well as from economic conditions, specifically, the additional wealth resulting from the exploration of the Marcellus Shale in our primary market and the limited loan growth opportunities in our primary market and surrounding areas. Mortgage banking firms, financial companies, financial affiliates of industrial

companies, brokerage firms, retirement fund management firms and even government agencies provide additional competition for loans and other financial services. The Bank is generally competitive with all competing financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

Trust and Investment Services; Oil and Gas Services

Our Investment and Trust Services Department offers professional trust administration, investment management services, estate planning and administration, and custody of securities. 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. Revenues and fees of the Trust Department are reflected in the Company's financial statements. As of September 30, 2012 and December 31, 2011, the Trust Department had \$104.5 and \$94.7 million of assets under management, respectively. The \$9.8 million increase is a result of \$2.1 million of net additions of trust assets, with the remaining increase attributable to fluctuations in the stock market since December 31, 2011.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance. The assets associated with these products are not included in the consolidated financial statements since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from \$78.1 million at December 31, 2011 to \$91.6 million at September 30, 2012. Fee income from the sale of these products is reflected in the Company's financial statements as a component of non-interest income in the Consolidated Statement of Income.

In addition to the trust and investment services offered, we have created an oil and gas division, which serves as a network of experts to assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. We have partnered with a professional firm to provide mineral management expertise and services to customers in our market who have been impacted by the Marcellus Shale exploration and drilling activities. Through this relationship, we are able to assist customers with the negotiation of lease payments and royalty percentages, protect their property, resolve leasing issues, account for and ensure the accuracy of royalty checks, distribute revenue to satisfy investment objectives and provide customized reports outlining payment and distribution information.

Results of Operations

Overview of the Income Statement

The Company had net income of \$10,666,000 for the first nine months of 2012 compared to earnings of \$9,355,000 for last year's comparable period, an increase of \$1,311,000 or 14.0%. Earnings per share for the first nine months of 2012 were \$3.66, compared to \$3.18 last year, representing a 15.2% increase. Annualized return on assets and return on equity for the nine months of 2012 were 1.62% and 17.74%, respectively, compared with 1.49% and 17.65% for last year's comparable period.

Net income for the three months ended September 30, 2012 was \$3,464,000 compared to earnings of \$3,378,000 in the comparable 2011 period, an increase of \$86,000 or 2.6%. Earnings per share for the three months ended September 30, 2012 and 2011 were \$1.19 and \$1.15 per share, respectively. Annualized return on assets and return on equity for the quarter ended September 30, 2012 was 1.58% and 16.78%, respectively, compared with 1.57% and 18.48% for the same 2011 period.

Net Interest Income

Net interest income, the most significant component of the Company's earnings, is the amount by which interest income generated from interest-earning assets exceeds interest expense on interest-bearing liabilities.

Net interest income for the first nine months of 2012 was \$22,838,000, an increase of \$1,619,000, or 7.6%, compared to the same period in 2011. For the first nine months of 2012, the provision for loan losses totaled \$315,000, a decrease of \$210,000 over the comparable period in 2011. Consequently, net interest income after the provision for loan losses was \$22,523,000 compared to \$20,694,000 during the first nine months of 2011.

For the three months ended September 30, 2012, net interest income was \$7,615,000 compared to \$7,207,000, an increase of \$408,000, or 5.7% over the comparable period in 2011. The provision for loan losses this quarter was \$105,000 compared to \$150,000 for last year's third quarter. Consequently, net interest income after the provision for loan losses was \$7,510,000 for the quarter ended September 30, 2012 compared to \$7,057,000 in 2011.

The following table sets forth the average balances of, and the interest earned or incurred on, for each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and interest rate spread created for the nine months and three months ended September 30, 2012 and 2011 on a tax equivalent basis (dollars in thousands):

Analysis of Average Balances and Interest Rates (1)

Nine Months Ended

September 30, 2012

September 30, 2011

| (dollars in thousands) | September 30, 2012 | | | September 30, 2011 | | |
|---|------------------------------|----------------|----------------------|------------------------------|----------------|----------------------|
| | Average Balance (1) \$ | Interest \$ | Average Rate % | Average Balance (1) \$ | Interest \$ | Average Rate % |
| ASSETS | | | | | | |
| Short-term investments: | | | | | | |
| Interest-bearing deposits at banks | 11,844 | 11 | 0.13 | 32,063 | 64 | 0.27 |
| Total short-term investments | 11,844 | 11 | 0.13 | 32,063 | 64 | 0.27 |
| Investment securities: | | | | | | |
| Taxable | 231,622 | 3,568 | 2.05 | 195,318 | 3,482 | 2.38 |
| Tax-exempt (3) | 94,235 | 4,232 | 5.99 | 88,657 | 4,073 | 6.13 |
| Total investment securities | 325,857 | 7,800 | 3.19 | 283,975 | 7,555 | 3.55 |
| Loans: | | | | | | |
| Residential mortgage loans | 193,919 | 9,317 | 6.42 | 188,108 | 9,648 | 6.86 |
| Commercial & agricultural loans | 234,250 | 10,998 | 6.27 | 222,859 | 10,684 | 6.41 |
| Loans to state & political subdivisions | 56,766 | 2,004 | 4.72 | 51,198 | 2,016 | 5.26 |
| Other loans | 10,337 | 652 | 8.43 | 10,869 | 691 | 8.50 |
| Loans, net of discount (2)(3)(4) | 495,272 | 22,971 | 6.20 | 473,034 | 23,039 | 6.51 |
| Total interest-earning assets | 832,973 | 30,782 | 4.94 | 789,072 | 30,658 | 5.19 |
| Cash and due from banks | 3,698 | | | 9,937 | | |
| Bank premises and equipment | 11,578 | | | 12,232 | | |
| Other assets | 30,952 | | | 28,605 | | |
| Total non-interest earning assets | 46,228 | | | 50,774 | | |
| Total assets | 879,201 | | | 839,846 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 200,296 | 602 | 0.40 | 188,088 | 708 | 0.50 |
| Savings accounts | 83,653 | 123 | 0.20 | 69,520 | 155 | 0.30 |
| Money market accounts | 71,126 | 228 | 0.43 | 55,605 | 219 | 0.53 |
| Certificates of deposit | 294,548 | 3,754 | 1.70 | 314,221 | 5,021 | 2.14 |

| | | | | | | |
|--|---------|--------|-------|---------|--------|-------|
| Total interest-bearing deposits | 649,623 | 4,707 | 0.97 | 627,434 | 6,103 | 1.30 |
| Other borrowed funds | 54,315 | 1,179 | 2.90 | 56,141 | 1,325 | 3.16 |
| Total interest-bearing liabilities | 703,938 | 5,886 | 1.12 | 683,575 | 7,428 | 1.45 |
| Demand deposits | 85,571 | | | 78,195 | | |
| Other liabilities | 9,526 | | | 7,394 | | |
| Total non-interest-bearing liabilities | 95,097 | | | 85,589 | | |
| Stockholders' equity | 80,166 | | | 70,682 | | |
| Total liabilities & stockholders' equity | 879,201 | | | 839,846 | | |
| Net interest income | | 24,896 | | | 23,230 | |
| Net interest spread (5) | | | 3.82% | | | 3.74% |
| Net interest income as a percentage of average interest-earning assets | | | 3.99% | | | 3.94% |
| Ratio of interest-earning assets to interest-bearing liabilities | | | 1.18 | | | 1.15 |

(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.

Analysis of Average Balances and Interest Rates (1)

Three Months Ended

September 30, 2012

September 30, 2011

| (dollars in thousands) | September 30, 2012 | | | September 30, 2011 | | |
|---|---------------------------|----------------|-------------------|---------------------------|----------------|-------------------|
| | Average Balance (1) \$ | Interest \$ | Average Rate % | Average Balance (1) \$ | Interest \$ | Average Rate % |
| ASSETS | | | | | | |
| Short-term investments: | | | | | | |
| Interest-bearing deposits at banks | 13,204 | 5 | 0.15 | 35,844 | 22 | 0.24 |
| Total short-term investments | 13,204 | 5 | 0.15 | 35,844 | 22 | 0.24 |
| Investment securities: | | | | | | |
| Taxable | 222,163 | 1,102 | 1.98 | 197,684 | 1,105 | 2.24 |
| Tax-exempt (3) | 93,999 | 1,392 | 5.92 | 93,122 | 1,410 | 6.06 |
| Total investment securities | 316,162 | 2,494 | 3.16 | 290,806 | 2,515 | 3.49 |
| Loans: | | | | | | |
| Residential mortgage loans | 193,725 | 3,081 | 6.33 | 188,598 | 3,221 | 6.78 |
| Commercial & agricultural loans | 236,734 | 3,680 | 6.18 | 224,384 | 3,615 | 6.39 |
| Loans to state & political subdivisions | 58,504 | 685 | 4.66 | 53,573 | 704 | 5.21 |
| Other loans | 10,342 | 217 | 8.35 | 10,917 | 233 | 8.47 |
| Loans, net of discount (2)(3)(4) | 499,305 | 7,663 | 6.11 | 477,472 | 7,773 | 6.46 |
| Total interest-earning assets | 828,671 | 10,162 | 4.88 | 804,122 | 10,310 | 5.09 |
| Cash and due from banks | 3,753 | | | 10,065 | | |
| Bank premises and equipment | 11,493 | | | 11,918 | | |
| Other assets | 30,256 | | | 29,315 | | |
| Total non-interest earning assets | 45,502 | | | 51,298 | | |
| Total assets | 874,173 | | | 855,420 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 200,603 | 192 | 0.38 | 193,177 | 220 | 0.45 |
| Savings accounts | 85,168 | 42 | 0.20 | 73,438 | 53 | 0.29 |
| | 74,370 | 75 | 0.40 | 59,429 | 79 | 0.53 |

| | | | | | | |
|--|---------|-------|-------|---------|-------|-------|
| Money market accounts | | | | | | |
| Certificates of deposit | 290,174 | 1,177 | 1.61 | 312,338 | 1,617 | 2.05 |
| Total interest-bearing deposits | 650,315 | 1,486 | 0.91 | 638,382 | 1,969 | 1.22 |
| Other borrowed funds | 46,834 | 373 | 3.17 | 55,144 | 437 | 3.14 |
| Total interest-bearing liabilities | 697,149 | 1,859 | 1.06 | 693,526 | 2,406 | 1.38 |
| Demand deposits | 85,724 | | | 80,758 | | |
| Other liabilities | 8,711 | | | 8,007 | | |
| Total non-interest-bearing liabilities | 94,435 | | | 88,765 | | |
| Stockholders' equity | 82,589 | | | 73,129 | | |
| Total liabilities & stockholders' equity | 874,173 | | | 855,420 | | |
| Net interest income | | 8,303 | | | 7,904 | |
| Net interest spread (5) | | | 3.82% | | | 3.71% |
| Net interest income as a percentage of average interest-earning assets | | | 3.99% | | | 3.90% |
| Ratio of interest-earning assets to interest-bearing liabilities | | | 1.19 | | | 1.16 |

(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 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. The following table represents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the periods ending September 30, 2012 and 2011 (in thousands):

| | For the Three Months Ended September 30 | | For the Nine Months Ended September 30 | |
|---|--|----------|---|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Interest and dividend income from investment securities | | | | |
| and interest bearing deposits at banks (non-tax adjusted) | \$ 2,026 | \$ 2,058 | \$ 6,372 | \$ 6,234 |
| Tax equivalent adjustment | 473 | 479 | 1,439 | 1,385 |
| Interest and dividend income from investment securities and interest bearing deposits at banks (tax equivalent basis) | \$ 2,499 | \$ 2,537 | \$ 7,811 | \$ 7,619 |
| Interest and fees on loans (non-tax adjusted) | \$ 7,448 | \$ 7,555 | \$ 22,352 | \$ 22,413 |
| Tax equivalent adjustment | 215 | 218 | 619 | 626 |
| Interest and fees on loans (tax equivalent basis) | \$ 7,663 | \$ 7,773 | \$ 22,971 | \$ 23,039 |
| Total interest income | \$ 9,474 | \$ 9,613 | \$ 28,724 | \$ 28,647 |
| Total interest expense | 1,859 | 2,406 | 5,886 | 7,428 |
| Net interest income | 7,615 | 7,207 | 22,838 | 21,219 |
| Total tax equivalent adjustment | 688 | 697 | 2,058 | 2,011 |
| Net interest income (tax equivalent basis) | \$ 8,303 | \$ 7,904 | \$ 24,896 | \$ 23,230 |

The following table shows the tax-equivalent effect of changes in volume and rate on interest income and expense (in thousands):

| | Three months ended September 30, 2012 vs. 2011 (1) | | | Nine months ended September 30, 2012 vs. 2011 (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 | \$ (10) | \$ (7) | \$ (17) | \$ (29) | \$ (24) | \$ (53) |
| Investment securities: | | | | | | |
| Taxable | 129 | (132) | (3) | 321 | (235) | 86 |
| Tax-exempt | 13 | (31) | (18) | 247 | (88) | 159 |
| Total investments | 142 | (163) | (21) | 568 | (323) | 245 |
| Loans: | | | | | | |
| Residential mortgage loans | 77 | (217) | (140) | 326 | (657) | (331) |
| Commercial & agricultural loans | 185 | (120) | 65 | 536 | (222) | 314 |
| Loans to state & political subdivisions | 60 | (79) | (19) | 208 | (220) | (12) |
| Other loans | (13) | (3) | (16) | (33) | (6) | (39) |
| Total loans, net of discount | 309 | (419) | (110) | 1,037 | (1,105) | (68) |
| Total Interest Income | 441 | (589) | (148) | 1,576 | (1,452) | 124 |
| Interest Expense: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| NOW accounts | 7 | (35) | (28) | 50 | (156) | (106) |
| Savings accounts | 7 | (18) | (11) | 47 | (79) | (32) |
| Money Market accounts | 17 | (21) | (4) | 27 | (18) | 9 |
| Certificates of deposit | (131) | (309) | (440) | (295) | (972) | (1,267) |
| Total interest-bearing deposits | (100) | (383) | (483) | (171) | (1,225) | (1,396) |
| Other borrowed funds | (67) | 3 | (64) | (41) | (105) | (146) |
| Total interest expense | (167) | (380) | (547) | (212) | (1,330) | (1,542) |
| Net interest income | \$ 608 | \$ (209) | \$ 399 | \$ 1,788 | \$ (122) | \$ 1,666 |

(1) The portion of the total change attributable to both volume and rate changes, which cannot be separated, has been allocated proportionally to the change due to volume and the change due to rate prior to allocation.

Tax equivalent net interest income increased from \$23.2 million for the 2011 nine month period ended September 30, 2011, to \$24.9 million in the 2012 nine month period ended September 30, 2012, an increase of \$1.7 million. The tax equivalent net interest margin increased from 3.94% for the first nine months of 2011 to 3.99% in 2012.

Total tax equivalent interest income for the 2012 nine month period increased \$124,000 as compared to the 2011 nine month period. This increase was primarily a result of an increase of \$1,576,000 due to an increase in average balance of interest earning assets of \$43.9 million for the comparable periods. The increase was offset by a decrease of \$1,452,000 due to change in rate, as the yield on interest earning assets decreased from 5.19% to 4.94% or 25 basis points for the comparable periods.

Tax equivalent investment income for the nine months ended September 30, 2012 increased \$245,000 over the same period last year. The average balance of total investment securities for the nine months ended September 30, 2012 increased by \$41.9 million from September 30, 2011, as a result of investing excess cash from increased deposit levels, and leveraging of overnight borrowings to purchase additional securities at higher interest rates than the overnight borrowings rate in the first half of 2012.

- The average balance of taxable securities increased by \$36.3 million while tax-exempt securities increased by \$5.6 million, which had the effect of increasing interest income by \$321,000 and \$247,000, respectively, due to volume.
- This increase was offset by a decrease in the yield on investment securities of 36 basis points from 3.55% to 3.19%, which corresponds to a decrease in interest income of \$323,000. The majority of this decrease is attributable to the change in yield on taxable securities, which experienced a decrease of 33 basis points from 2.38% to 2.05%. The yield on investments declined due to the amount of purchases we made in the current low interest rate environment. For a discussion of the Company's current investment strategy, see the "Financial Condition – Investments".

The purchase of tax-exempt securities, along with municipal loans and investment tax credits, allows us to manage and reduce our effective tax rate as well as the overall yield on our interest earning assets.

Total loan interest income decreased \$68,000 for the nine months ended September 30, 2012 compared to the same period last year.

- The average balance of commercial and agricultural loans increased \$11.4 million from a year ago as we continue to emphasize and strive for growth in this segment of the loan portfolio utilizing disciplined underwriting standards, while meeting the needs of our customers. This had a positive impact of \$536,000 on total interest income due to volume, which was offset by a decrease of \$222,000 due to rate.
- Interest income on residential mortgage loans decreased \$331,000 of which \$657,000 was due to rate, partially offset by an increase of \$326,000 as a result of volume. The average balance increased \$5.8 million due to the Company's 2011 fourth quarter decision to not sell certain conforming rate loans that historically it has sold for interest rate risk management purposes, due to decline in the volume of non-conforming residential real estate loans and the interest rate environment for investments at that time.

Total interest expense decreased \$1,542,000 for the nine months ended September 30, 2012 compared with last year. This decrease is primarily due to a change in rate, accounting for a \$1,330,000 decrease in our interest expense. The average interest rate on interest-bearing liabilities decreased 33 basis points, from 1.45% to 1.12%. The continued low interest rate environment prompted by the Federal Reserve and current economic conditions had the effect of decreasing our short-term borrowing costs as well as rates on all deposit products. While the Company's rates on deposit products are below historical averages they are competitive with rates paid by other institutions in the marketplace. (see also "Financial Condition – Deposits").

- Interest expense on certificates of deposits decreased \$1,267,000 over the same period last year. There was a decrease in the average rate on certificates of deposit from 2.14% to 1.70% resulting in a decrease in interest expense of \$972,000. Additionally, the average balance of certificates of deposit decreased \$19.7 million causing a decrease in interest expense of \$295,000.

Tax equivalent net interest income for the three months ended September 30, 2012 was \$8,303,000 which compares to \$7,904,000 for the same period last year. This represents an increase of \$399,000.

Total tax equivalent interest income was \$10,162,000 for the 2012 three month period ended September 30, 2012, compared with \$10,310,000 for the comparable period last year, a decrease of \$148,000:

- Of this amount, \$589,000 was a result of a decrease of 21 basis points on our yield on interest earning assets from 5.09% to 4.88%. This decrease was offset by an increase of \$441,000, due to an increase in volume as a result of a \$24.5 million increase in interest earning assets.
- Total investment income decreased by \$21,000 compared to same period last year. There was a decrease in the average rate earned on investments of 33 basis points resulting in a decrease in investment income of \$163,000. This was offset by an increase in the average balance of investment securities of \$25.4 million, which resulted in additional income of \$142,000.
- Total loan interest income decreased \$110,000 compared to last year. This was predominantly due to a decrease in rate of 35 basis points from 6.46% to 6.11% partially offset by a \$21.8 million increase in average loans outstanding.

Total interest expense decreased \$547,000 for the three months ended September 30, 2012 compared with last year as a result of a decrease in the average rate on interest-bearing liabilities of 32 basis points from 1.38% to 1.06% accounting for a \$380,000 decrease in interest expense. Additionally, due to a \$22.2 million decrease in the average balance of certificates of deposit, there was a \$131,000 decrease in interest expense.

Provision for Loan Losses

For the nine month period ending September 30, 2012, we recorded a provision for loan losses of \$315,000, which represents a decrease of \$210,000 from the \$525,000 provision recorded in the corresponding nine months of last year. The provision was lower in 2012 than 2011 due to the improvement in non-performing assets that has occurred since September 30, 2011. (see “Financial Condition – Allowance for Loan Losses and Credit Quality Risk”).

For the three months ending September 30, 2012, we recorded a provision of \$105,000 compared to \$150,000 in 2011.

Non-interest Income

The following table shows the breakdown of non-interest income for the three and nine months ended September 30, 2012 and 2011 (in thousands):

| | Nine months ended September 30, | | Change | |
|---------------------------------------|---------------------------------|----------|--------|-------|
| | 2012 | 2011 | Amount | % |
| Service charges | \$ 3,346 | \$ 3,258 | \$ 88 | 2.7 |
| Trust | 472 | 466 | 6 | 1.3 |
| Brokerage and insurance | 305 | 297 | 8 | 2.7 |
| Gains on loans sold | 287 | 111 | 176 | 158.6 |
| Investment securities gains, net | 561 | 351 | 210 | 59.8 |
| Earnings on bank owned life insurance | 378 | 371 | 7 | 1.9 |
| Other | 342 | 323 | 19 | 5.9 |
| Total | \$ 5,691 | \$ 5,177 | \$ 514 | 9.9 |

| | Three months ended September 30, | | Change | |
|---------------------------------------|----------------------------------|----------|---------|--------|
| | 2012 | 2011 | Amount | % |
| Service charges | \$ 1,139 | \$ 1,185 | \$ (46) | (3.9) |
| Trust | 148 | 163 | (15) | (9.2) |
| Brokerage and insurance | 80 | 79 | 1 | 1.3 |
| Gains on loans sold | 102 | 36 | 66 | 183.3 |
| Investment securities gains, net | 240 | 117 | 123 | 105.1 |
| Earnings on bank owned life insurance | 128 | 126 | 2 | 1.6 |
| Other | 109 | 122 | (13) | (10.7) |
| Total | \$ 1,946 | \$ 1,828 | \$ 118 | 6.5 |

Non-interest income for the nine months ended September 30, 2012 totaled \$5,691,000, an increase of \$514,000 when compared to the same period in 2011. During the first nine months of 2012, investment security gains amounted to \$561,000 compared to gains of \$351,000 last year. We sold four agency securities for gains totaling \$50,000, U.S. treasuries for a gain of \$95,000, eleven mortgage backed securities in government sponsored entities for gains totaling \$358,000, and a portion of a financial institution equity holding for a gain of \$58,000 due to favorable market conditions. In 2011, we sold thirteen mortgage backed securities in government sponsored entities for gains totaling

\$231,000, three agency bonds for gains of \$116,000, a portion of a financial institution equity holding for a net gain of \$43,000 and four municipal bonds for a loss of \$39,000.

For the first nine months of 2012, account service charges totaled \$3,346,000, an increase of \$88,000 or 2.7%, when compared to the same period in 2011. There was an increase of \$60,000 attributable to customers' usage of their debit cards which continues to become a larger percentage of service charge income as the Company is encouraging its customers to use their debit cards for making purchases by providing a deposit product that rewards customers for their usage. Additionally, ATM income increased \$34,000 as a result of an increase in the Bank's fees and increased activity associated with non-customers use of the Bank's ATMs. Management continues to monitor regulatory changes associated with the Dodd-Frank Act to determine the level of impact that these regulations will have on the fees that the Company realizes.

Gains on loans sold increased \$176,000, or 158.6% for the nine months ended September 30, 2012 to \$287,000. The increase is due to the significant refinancing activity of secondary market loans, as a result of the historically low interest rate environment. During the first three quarters of 2012, the Company received proceeds of \$21.9 million from the sale of conforming loans compared to \$7.6 million of proceeds for the comparable 2011 period.

For the three month period ended September 30, 2012, the increases experienced in gains on loans sold and investment securities gains are consistent with the year to date increases described above.

Non-interest Expense

The following tables reflect the breakdown of non-interest expense for the three and nine months ended September 30, 2012 and 2011 (in thousands):

| | Nine months ended September 30, | | Change | |
|--------------------------------|------------------------------------|-----------|--------|--------|
| | 2012 | 2011 | Amount | % |
| Salaries and employee benefits | \$ 8,126 | \$ 7,560 | \$ 566 | 7.5 |
| Occupancy | 928 | 1,014 | (86) | (8.5) |
| Furniture and equipment | 315 | 338 | (23) | (6.8) |
| Professional fees | 701 | 526 | 175 | 33.3 |
| FDIC insurance | 353 | 547 | (194) | (35.5) |
| Pennsylvania shares tax | 441 | 439 | 2 | 0.5 |
| Other | 3,488 | 3,496 | (8) | (0.2) |
| Total | \$ 14,352 | \$ 13,920 | \$ 432 | 3.1 |

| | Three months ended September 30, | | Change | |
|--------------------------------|-------------------------------------|----------|--------|--------|
| | 2012 | 2011 | Amount | % |
| Salaries and employee benefits | \$ 2,705 | \$ 2,527 | \$ 178 | 7.0 |
| Occupancy | 304 | 295 | 9 | 3.1 |
| Furniture and equipment | 113 | 115 | (2) | (1.7) |
| Professional fees | 209 | 197 | 12 | 6.1 |
| FDIC insurance | 115 | 47 | 68 | 144.7 |
| Pennsylvania shares tax | 115 | 146 | (31) | (21.2) |
| Other | 1,398 | 1,171 | 227 | 19.4 |
| Total | \$ 4,959 | \$ 4,498 | \$ 461 | 10.2 |

Non-interest expenses increased \$432,000 for the nine months ended September 30, 2012 compared to the same period in 2011. Salaries and employee benefits increased \$566,000 or 7.5%. Merit increases effective the beginning of 2012 and an increase in full time equivalent employees of 5.6 employees to 179.6 full time equivalent employees, as part of implementing the Bank's strategic plan, accounted for an increase of approximately \$348,000. Other increases included an increase of \$78,000 for expenses related to providing employee's health insurance and a \$74,000 increase related to profit sharing expense.

Occupancy expenses decreased as a result of milder winter weather conditions in 2012. FDIC insurance decreased \$194,000 in 2012 primarily due to changes in the FDIC assessment base and the assessment formula implemented in the second quarter of 2011. Professional fees increased by \$175,000 primarily due to the Bank's charter conversion from a national bank to a Pennsylvania chartered bank and trust company that was completed in the second quarter of 2012.

For the three months ended, September 30, 2012, salaries and employee benefits increased by \$178,000 due to the reasons described above, which include merit increases, increased staffing, increased insurance costs and profit sharing expenses. The decrease in Pennsylvania shares tax of \$31,000 is the result of a tax credit obtained in the third quarter of 2012. The increase in other expenses of \$227,000 is the result of several items. Other real estate owned expenses, which are included in other expenses, increased by \$79,000 as a result of having to pay real estate taxes for certain customers in the third quarter of 2012. Also included in other expenses was an increase in contributions of \$59,000, as certain contributions typically made in the fourth quarter to educational foundations, were made in the third quarter of 2012. As a result of the Bank's charter conversion, supplies, printing and forms, which are included in other expenses, increased \$65,000.

Provision for Income Taxes

The provision for income taxes was \$3,196,000 for the nine month period ended September 30, 2012 compared to \$2,596,000 for the same period in 2011. The increase is primarily attributable to an increase in income before provision for income taxes of \$1,911,000. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 23.1% and 21.8% for the first nine months of 2012 and 2011, respectively, compared to the statutory rate of 34%.

For the three-months ended September 30, 2012, the provision for income taxes was \$1,033,000 compared to \$1,009,000 for the same period in 2011. The increase is primarily attributable to an increase in income before provision for income taxes of \$110,000. Our effective tax rate was 23.0% for both of the three month periods ended September 30, 2012 and 2011, compared to the statutory rate of 34%.

We have invested in four limited partnership agreements that established low-income housing projects in our market areas. We anticipate recognizing an aggregate of \$1.7 million of tax credits over the next eleven years, with an additional \$15,000 to be recognized during 2012.

Financial Condition

Total assets were \$876.2 million at September 30, 2012, a decrease of \$2.4 million, or 0.3% from \$878.6 million at December 31, 2011. Cash decreased \$19.7 million or 64.8% to \$10.7 million. Investment securities increased 1.0% to \$322.0 million and net loans increased 2.4% to \$492.5 million at September 30, 2012. Total deposits decreased \$4.8 million or 0.7% to \$729.2 million since year-end 2011. Borrowed funds have decreased \$5.9 million to \$48.0 million compared with \$53.9 million at year-end.

Cash and Cash Equivalents

Cash and cash equivalents totaled \$10.7 million at September 30, 2012 compared to \$30.4 million at December 31, 2011, a decrease of \$19.7 million. The decrease in cash is due to the Company's decision as discussed in more detail below to purchase additional investments in the first quarter of 2012 and loan growth. Management actively measures and evaluates its liquidity through our Asset-Liability Committee and believes its 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, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

Investments

The following table shows the composition of the investment portfolio as of September 30, 2012 and December 31, 2011 (dollars in thousands):

| | September 30, 2012 | | December 31, 2011 | |
|---|--------------------|-------|-------------------|-------|
| | Amount | % | Amount | % |
| Available-for-sale: | | | | |
| U. S. Agency securities | \$ 149,097 | 46.3 | \$ 168,600 | 52.9 |
| Obligations of state & political subdivisions | 100,975 | 31.4 | 101,547 | 31.9 |
| Corporate obligations | 11,215 | 3.5 | 8,460 | 2.7 |
| Mortgage-backed securities in government sponsored entities | 59,379 | 18.4 | 38,974 | 12.2 |
| Equity securities in financial institutions | 1,373 | 0.4 | 1,242 | 0.3 |
| Total | \$ 322,039 | 100.0 | \$ 318,823 | 100.0 |

| | September 30, 2012/ December 31, 2011 | |
|---|--|--------|
| | Change Amount | % |
| Available-for-sale: | | |
| U. S. Agency securities | \$ (19,503) | (11.6) |
| Obligations of state & political subdivisions | (572) | (0.6) |
| Corporate obligations | 2,755 | 32.6 |
| Mortgage-backed securities in government sponsored entities | 20,405 | 52.4 |
| Equity securities in financial institutions | 131 | 10.5 |
| Total | \$ 3,216 | 1.0 |

Our investment portfolio increased by \$3.2 million or 1.0% from December 31, 2011 to September 30, 2012. During 2012, we purchased approximately \$59.6 million of U.S. agency obligations, \$3.9 million of U.S. Treasury notes, \$36.5 million of mortgage backed securities in government sponsored entities, \$6.6 million of state and local obligations and \$2.6 million of corporate obligations, which helped offset the \$11.2 million of principal repayments and \$75.3 million of calls and maturities that occurred during the nine month period. We also sold \$19.8 million of various securities at a gain of \$561,000. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio for the nine month period ending September 30, 2012 yielded 3.19% compared to 3.55% for the same period in 2011 on a tax equivalent basis.

Due to the Federal Reserve announcement that rates would likely remain extremely low through late 2014, the Company's investment strategy changed slightly in the first half of 2012 compared to the strategy in place in 2011. The previous strategy employed by the Company had resulted in a relatively short duration in the investment portfolio. As a result of the Federal Reserve's commitment to a low rate policy, the Company implemented a strategy to increase portfolio duration through the purchase of certain mortgage backed securities and longer term agencies to provide additional interest income. This strategy maintained a defensive posture to future rising rates by selecting securities that had limited extension risk. By increasing duration with defensive securities the Bank was able to increase interest income with minimal additional interest rate risk. As part of implementing this strategy, in the first quarter of 2012, the Company purchased certain investment securities utilizing overnight borrowings, which were repaid in the second quarter as other investment securities matured or were called. We believe this strategy, while having a positive impact on 2012 earnings, will also enable us to reinvest cash flows in the next two to five years when we believe investment opportunities will be improved.

Management continues to monitor the earnings performance and the liquidity of the investment portfolio on a regular basis. Through active balance sheet management and analysis of the securities portfolio, the Company believes it maintains sufficient liquidity to satisfy depositor requirements and various credit needs of its customers.

Loans

The following table shows the composition of the loan portfolio as of September 30, 2012 and December 31, 2011 (dollars in thousands):

| | September 30, 2012 | | December 31, 2011 | |
|-------------------------------------|-----------------------|-------|----------------------|-------|
| | Amount | % | Amount | % |
| Real estate: | | | | |
| Residential | \$ 182,999 | 36.7 | \$ 184,034 | 37.7 |
| Commercial | 169,607 | 34.0 | 165,826 | 34.0 |
| Agricultural | 18,300 | 3.7 | 19,224 | 3.9 |
| Construction | 12,131 | 2.4 | 8,481 | 1.7 |
| Consumer | 10,527 | 2.1 | 10,746 | 2.2 |
| Commercial and other loans | 46,654 | 9.3 | 44,299 | 9.1 |
| State & political subdivision loans | 59,008 | 11.8 | 54,899 | 11.4 |
| Total loans | 499,226 | 100.0 | 487,509 | 100.0 |
| Less allowance for loan losses | 6,734 | | 6,487 | |
| Net loans | \$ 492,492 | | \$ 481,022 | |

| | September 30, 2012/ December 31, 2011 | |
|-------------------------------------|--|-------|
| | Change Amount | % |
| Real estate: | | |
| Residential | \$ (1,035) | (0.6) |
| Commercial | 3,781 | 2.3 |
| Agricultural | (924) | (4.8) |
| Construction | 3,650 | 43.0 |
| Consumer | (219) | (2.0) |
| Commercial and other loans | 2,355 | 5.3 |
| State & political subdivision loans | 4,109 | 7.5 |
| Total loans | \$ 11,717 | 2.4 |

The Company's lending is focused in the north central Pennsylvania market and the southern tier of New York. The composition of our loan portfolio consists principally of retail lending, which includes single-family residential mortgages and other consumer lending, and commercial lending primarily to locally owned small businesses. New loans are generated primarily from direct loans to our existing customer base, with new customers generated by referrals from real estate brokers, building contractors, attorneys, accountants and existing customers and the efforts and expertise of our business development officers.

Total loans increased approximately \$11.7 million or 2.4% during the first nine months of 2012. Commercial real estate, construction, commercial and other loans and state and political subdivision loans have increased \$3.8 million, \$3.7 million, \$2.4 million and \$4.1 million, respectively. Residential and agricultural real estate decreased \$1.0

million and \$924,000, respectively.

While activity related to the Marcellus Shale natural gas exploration has slowed in the first nine months of 2012, we continue to recognize the opportunities created by this activity, but pursue these opportunities prudently and cautiously. The growth in commercial real estate lending, construction, and other commercial loans reflects the Company's focus on commercial lending as a means to increase loan growth and obtain deposits from farmers and small businesses throughout our market area. The increase in state and political subdivision loans is the result of several relationships within our market area. We work closely with local municipalities and school districts to meet their needs that otherwise would be provided by the municipal bond market. Commercial real estate and other commercial loan demand is subject to significant competitive pressures, the local economy which is currently being impacted significantly by the Marcellus Shale gas exploration area, the yield curve and the strength of the overall regional and national economy.

During the first nine months of 2012, we continued to experience lower demand for non-conforming residential real estate loans. Factors impacting this decline include demand for conforming rate loans and recessionary pressures outside of the local Marcellus Shale gas region. Loan demand for conforming mortgages, which the Company generally sells on the secondary market, has increased as qualified customers continue to take advantage of the low interest rate environment. Through the first nine months of 2012, we received proceeds of \$21.9 million from the sale of loans in the secondary market compared to \$7.6 million through the same period last year. The Company recognizes fee income for servicing these sold loans, which is included in non-interest income in the Consolidated Statement of Income. Management continues to look for ways to ensure that our customers choose the Company for their mortgage needs. This includes partnering with a third party to provide access to government supported loan programs sponsored by the Federal Housing Administration and the U.S. Department of Veteran Affairs and to implement technologies that improve customer service, by making it easier and more efficient for customers to obtain a mortgage.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level which in management's judgment is adequate to absorb probable future loan losses inherent in the loan portfolio. The provision for loan losses is charged against current income. Loans deemed not collectable are charged-off against the allowance while subsequent recoveries increase the allowance. The following table presents an analysis of the allowance for loan losses and non-performing loans and assets as of and for the nine months ended September 30, 2012 and for the years ended December 31, 2011, 2010, 2009 and 2008 (dollars in thousands):

| | September 30 2012 | 2011 | December 31, 2010 | 2009 | 2008 |
|--|----------------------|------------|----------------------|------------|------------|
| Balance | | | | | |
| at beginning of period | \$ 6,487 | \$ 5,915 | \$ 4,888 | \$ 4,378 | \$ 4,197 |
| Charge-offs: | | | | | |
| Real estate: | | | | | |
| Residential | 49 | 101 | 147 | 76 | 31 |
| Commercial | 2 | 29 | 53 | 236 | 36 |
| Agricultural | - | - | - | 1 | 20 |
| Consumer | 36 | 71 | 35 | 80 | 44 |
| Commercial and other loans | 20 | 6 | 173 | 153 | 115 |
| Total loans charged-off | 107 | 207 | 408 | 546 | 246 |
| Recoveries: | | | | | |
| Real estate: | | | | | |
| Residential | - | - | 4 | 1 | 6 |
| Commercial | 7 | 15 | 11 | 1 | - |
| Agricultural | - | - | - | - | 20 |
| Consumer | 25 | 57 | 45 | 52 | 19 |
| Commercial and other loans | 7 | 32 | 120 | 77 | 52 |
| Total loans recovered | 39 | 104 | 180 | 131 | 97 |
| Net loans charged-off | 68 | 103 | 228 | 415 | 149 |
| Provision charged to expense | 315 | 675 | 1,255 | 925 | 330 |
| Balance at end of period | \$ 6,734 | \$ 6,487 | \$ 5,915 | \$ 4,888 | \$ 4,378 |
| Loans outstanding at end of period | \$ 499,226 | \$ 487,509 | \$ 473,517 | \$ 456,384 | \$ 432,814 |
| Average loans outstanding, net | \$ 495,272 | \$ 474,972 | \$ 468,620 | \$ 442,921 | \$ 423,382 |
| Non-performing assets: | | | | | |
| Non-accruing loans | \$ 8,255 | \$ 9,165 | \$ 11,853 | \$ 5,871 | \$ 2,202 |
| Accrual loans - 90 days or more past due | 439 | 275 | 692 | 884 | 383 |
| Total non-performing loans | \$ 8,694 | \$ 9,440 | \$ 12,545 | \$ 6,755 | \$ 2,585 |
| Foreclosed assets held for sale | 463 | 860 | 693 | 302 | 591 |
| Total non-performing assets | \$ 9,157 | \$ 10,300 | \$ 13,238 | \$ 7,057 | \$ 3,176 |

| | | | | | |
|--|--------|--------|--------|--------|---------|
| Annualized net charge-offs to average loans | 0.02% | 0.02% | 0.05% | 0.09% | 0.04% |
| Allowance to total loans | 1.35% | 1.33% | 1.25% | 1.07% | 1.01% |
| Allowance to total non-performing loans | 77.46% | 68.72% | 47.15% | 72.36% | 169.36% |
| Non-performing loans as a percent of loans net of unearned income | 1.74% | 1.94% | 2.65% | 1.48% | 0.60% |
| Non-performing assets as a percent of loans net of unearned income | 1.83% | 2.11% | 2.80% | 1.55% | 0.73% |

The Company utilizes a disciplined and thorough loan review process based upon our internal loan policy approved by the Company's Board of Directors. The purpose of the review is to assess loan quality, analyze delinquencies, identify problem loans, evaluate potential charge-offs and recoveries, and assess general overall economic conditions in the markets served. An external independent loan review is performed on our commercial portfolio semi-annually. The external consultant is engaged to 1) review a minimum of 60% of the dollar volume of the commercial loan portfolio (commercial and agricultural real estate, commercial and other loans and state and political subdivision loans) on an annual basis, 2) review a sample of new commercial/agricultural loans originated in the last year, 3) review all relationships in aggregate over \$500,000, 4) review all aggregate loan relationships over \$100,000 which are over 90 days past due or classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate. As part of this review, our underwriting process and loan grading system is evaluated.

Management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate as of September 30, 2012. However, future adjustments could be required if circumstances differ substantially from assumptions and estimates used in making the initial determination. A prolonged downturn in the economy, continued high unemployment rates, significant changes in the value of collateral and delays in receiving financial information from borrowers could result in increased levels of non-performing assets, charge-offs, loan loss provisions and reduction in income. Additionally, bank regulatory agencies periodically examine the Bank's allowance for loan losses. The banking agencies could require the recognition of additions to the allowance for loan losses based upon their judgment of information available to them at the time of their examination.

On a monthly basis, problem loans are identified and updated primarily using internally prepared past due reports. Based on data surrounding the collection process of each identified loan, the loan may be added or deleted from the monthly watch list. The watch list includes loans graded special mention, substandard, doubtful, and loss, as well as additional loans that management may chose to include. Watch list loans are continually monitored going forward until satisfactory conditions exist that allow management to upgrade and remove the loan. In certain cases, loans may be placed on non-accrual status or charged-off based upon management's evaluation of the borrower's ability to pay. All commercial loans, which include commercial real estate, agricultural real estate, state and political subdivision loans and other commercial loans, on non-accrual are evaluated quarterly for impairment.

The adequacy of the allowance for loan losses is subject to a formal, quarterly analysis by management of the Company. In order to better analyze the risks associated with the loan portfolio, the entire portfolio is divided into several categories. As stated above, loans on non-accrual status are specifically reviewed for impairment and given a specific reserve, if appropriate. Loans evaluated and not found to be impaired are included with other performing loans, by category, by their respective homogenous pools. Three year average historical loss factors are calculated for each pool and applied to the performing portion of the loan category. The historical loss factors for both reviewed and homogeneous pools are adjusted based upon the following qualitative factors:

- Level of and trends in delinquencies, impaired/classified loans
 - Change in volume and severity of past due loans
 - Volume of non-accrual loans
 - Volume and severity of classified, adversely or graded loans
 - Level of and trends in charge-offs and recoveries
 - Trends in volume, terms and nature of the loan portfolio
- Effects of any changes in risk selection and underwriting standards and any other changes in lending and recovery policies, procedures and practices
 - Changes in the quality of the Bank's loan review system
 - Experience, ability and depth of lending management and other relevant staff
 - National, state, regional and local economic trends and business conditions
 - General economic conditions
 - Unemployment rates
 - Inflation / Consumer Price Index
 - Changes in values of underlying collateral for collateral-dependent loans
- Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses
 - Existence and effect of any credit concentrations, and changes in the level of such concentrations.

The balance in the allowance for loan losses was \$6,734,000 or 1.35% of total loans as of September 30, 2012 as compared to \$6,487,000 or 1.33% of loans as of December 31, 2011. The \$247,000 increase is a result of a \$315,000 provision for the first nine months less net charge-offs of \$68,000. Gross charge-offs for the first nine months of 2012 were \$107,000. Gross charge-offs for all of 2011 were \$207,000. 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)
as of September 30, 2012 and December 31, 2011, 2010, 2009 and 2008:

43

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| | September 30, | | | | December 31 | | | | | | | |
|-------------------------------------|---------------|-------|----------|-------|-------------|-------|----------|-------|----------|-------|--|--|
| | 2012 | | 2011 | | 2010 | | 2009 | | 2008 | | | |
| | Amount | % | Amount | % | Amount | % | Amount | % | Amount | % | | |
| Real estate loans: | | | | | | | | | | | | |
| Residential | \$ 865 | 36.7 | \$ 805 | 37.7 | \$ 969 | 39.1 | \$ 801 | 42.7 | \$ 694 | 46.0 | | |
| Commercial, agricultural | 4,231 | 37.7 | 4,132 | 37.9 | 3,380 | 36.2 | 2,864 | 33.6 | 2,303 | 28.8 | | |
| Construction | 26 | 2.4 | 15 | 1.7 | 22 | 2.1 | 20 | 1.2 | 5 | 2.6 | | |
| Consumer | 104 | 2.1 | 111 | 2.2 | 108 | 2.4 | 131 | 2.6 | 449 | 2.7 | | |
| Commercial and other loans | 666 | 9.3 | 674 | 9.1 | 983 | 10.0 | 918 | 9.7 | 807 | 8.8 | | |
| State & political subdivision loans | 274 | 11.8 | 235 | 11.4 | 137 | 10.2 | 93 | 10.2 | 19 | 11.1 | | |
| Unallocated | 568 | N/A | 515 | N/A | 316 | N/A | 61 | N/A | 101 | N/A | | |
| Total allowance for loan losses | \$ 6,734 | 100.0 | \$ 6,487 | 100.0 | \$ 5,915 | 100.0 | \$ 4,888 | 100.0 | \$ 4,378 | 100.0 | | |

As a result of previous loss experiences and other the risk factors utilized in determining the allowance, the Bank's allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 37.7% of the loan portfolio, 62.8% of the allowance is assigned to this segment of the loan portfolio as these loans have more inherent risks than residential real estate or loans to state and political subdivisions.

The following table identifies amounts of loans contractually past due 30 to 89 days and non-performing loans by loan category, as well as the change from December 31, 2011 to September 30, 2012 in non-performing loans(dollars in thousands). Non-performing loans include those loans that are contractually past due 90 days or more and non-accrual loans. Interest does not accrue on non-accrual loans. Subsequent cash payments received are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of its ultimate ability to collect principal and interest.

| | September 30, 2012 | | | | December 31, 2011 | | | |
|----------------------------|-----------------------|------------------|-------------|----------------------|-----------------------|------------------|-------------|----------------------|
| | Non-Performing Loans | | | | Non-Performing Loans | | | |
| | 30 - 89 Days Past Due | 90 Days Past Due | Non-accrual | Total Non-Performing | 30 - 89 Days Past Due | 90 Days Past Due | Non-accrual | Total Non-Performing |
| Real estate: | | | | | | | | |
| Residential | \$ 1,020 | 142 | \$ 694 | \$ 836 | \$ 859 | 99 | \$ 554 | \$ 653 |
| Commercial | 465 | 295 | 7,224 | 7,519 | 731 | 176 | 8,094 | 8,270 |
| Agricultural | - | - | - | - | 143 | - | - | - |
| Construction | - | - | - | - | - | - | - | - |
| Consumer | 57 | 2 | - | 2 | 93 | - | - | - |
| Commercial and other loans | 165 | - | 337 | 337 | 8 | - | 517 | 517 |
| Total nonperforming loans | \$ 1,702 | 439 | \$8,255 | \$ 8,694 | \$ 1,834 | 275 | \$ 9,165 | \$ 9,440 |

Change in
Non-Performing
Loans
September 30,
2012/ December 31,
2011

| | Amount | % |
|---------------------------------|----------|--------|
| Real estate: | | |
| Residential | \$ 183 | 28.0 |
| Commercial | (751) | (9.1) |
| Agricultural | - | N/A |
| Construction | - | N/A |
| Consumer | 2 | N/A |
| Commercial and other loans | (180) | (34.8) |
| Total nonperforming loans | \$ (746) | (7.9) |

For the nine month period ending September 30, 2012, we recorded a provision for loan losses of \$315,000, which compares to \$525,000 for the same time period in 2011. The decrease is attributable to the decrease in non-performing loans in comparison to year end. Non-performing loans decreased \$746,000 or 7.9%, from December 31, 2011 to September 30, 2012. Approximately 79.1% of the Bank's non-performing loans are associated with the following three customer relationships:

- A commercial customer with a total loan relationship of \$5.0 million secured by 165 residential properties and one commercial building is considered non-accrual as of September 30, 2012. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. The loan remained current throughout 2011 and 2012. Management continues to monitor the financial condition of this borrower and has received the 2011 financial statements and tax returns, which continue to show weakness. As a result of the loan being considered non-accrual and payments being made on the loans through September 30, 2012, there is no specific reserve allocation as of September 30, 2012.
- A commercial customer with a relationship of approximately \$969,000 is considered non-accrual as of September 30, 2012. \$669,000 of the relationship is subject to USDA guarantees. The current economic conditions related to the timber industry have significantly impacted the cash flows from the customer's activities. Management reviewed the collateral and guarantees and determined that a specific reserve allocation of \$116,000 was required as of September 30, 2012 based on the appraised value of collateral.
- A commercial customer with a relationship of approximately \$956,000 is considered non-accrual as of September 30, 2012. The current recessionary economic conditions have significantly impacted the cash flows from the customer's activities. Management reviewed the collateral and determined that a specific reserve allocation of \$243,000 was required as of September 30, 2012 based on the appraised value of collateral. The customer has indicated a willingness to provide additional collateral in order to borrow additional funds to complete the project associated with this loan, which management is currently evaluating.

Management of the Bank believes that the allowance for loan losses is adequate, which is based on the following factors:

- While non-performing loans are still higher than the Company's historical levels, 56.9% of this balance is associated with one customer, whose debt is current through October 31, 2012.
- Net and gross charge-offs continue to be low in relation to the size of the Bank's loan portfolio and compared to our peer group.
- We have not experienced the significant decrease in the collateral values of local residential, commercial or agricultural real estate loan portfolios as seen in other parts of the country. Additionally, our market area is predominately centered in the Marcellus Shale natural gas exploration and drilling area. These natural gas exploration and drilling activities have significantly impacted the overall interest in real estate in our market area due to the related lease and royalty revenues associated with it. The natural gas activities have had a positive impact on the value of local real estate.

Bank Owned Life Insurance

The Company purchased bank owned life insurance to offset future employee benefit costs. As of September 30, 2012, the cash surrender value of this life insurance is \$14,047,000, which has resulted in income recognized in the first nine months ended September 30, 2012 of \$378,000 compared to \$371,000 for the same period in 2011. The use of life insurance policies provides the Bank with an asset that will generate earnings to partially offset the current costs of benefits and eventually (at the death of the individuals) provides partial recovery of cash outflows associated with the benefits.

Premises and Equipment

Premises and equipment decreased approximately \$283,000 from \$11.7 million at December 31, 2011 to \$11.4 million at September 30, 2012. This occurred primarily as a result of depreciation for 2012 of \$454,000 offset by purchases totaling approximately \$179,000.

Deposits

The following table shows the composition of deposits as of September 30, 2012 and December 31, 2011 (dollars in thousands):

| | September 30, 2012 | | December 31, 2011 | |
|-------------------------------|-----------------------|-------|----------------------|-------|
| | Amount | % | Amount | % |
| Non-interest-bearing deposits | \$ 84,767 | 11.6 | \$ 85,605 | 11.6 |
| NOW accounts | 196,510 | 27.0 | 200,897 | 27.4 |
| Savings deposits | 86,327 | 11.8 | 79,659 | 10.8 |
| Money market deposit accounts | 75,497 | 10.4 | 67,223 | 9.2 |
| Certificates of deposit | 286,106 | 39.2 | 300,609 | 41.0 |
| Total | \$ 729,207 | 100.0 | \$ 733,993 | 100.0 |

| | September 30, 2012/ December 31, 2011 Change | |
|-------------------------------|--|-------|
| | Amount | % |
| Non-interest-bearing deposits | \$ (838) | (1.0) |
| NOW accounts | (4,387) | (2.2) |
| Savings deposits | 6,668 | 8.4 |
| Money market deposit accounts | 8,274 | 12.3 |
| Certificates of deposit | (14,503) | (4.8) |
| Total | \$ (4,786) | (0.7) |

Deposits decreased \$4.8 million or 0.7%, since December 31, 2011. The decrease in deposits is a result of us lowering certificate of deposit rates to match market and competitor rates. This resulted in certain customers of the Bank withdrawing deposits from the Bank, as they looked for higher interest rates. Additionally, certain customers have transferred a portion of their deposits to the Company's trust department. While deposits have decreased in the current year, our market continues to be positively impacted by the Marcellus Shale gas exploration activities and we have developed products specifically targeting customers that have benefited from this activity. We believe that our historical financial performance, reputation as a strong, local community bank, acquisitions of local competitors from institutions outside of our general market area and our focus on developing relationships with the local municipalities has positioned the Company as a leading financial institution within our service area with the ability to meet our customers' needs and expectations.

As of September 30, 2012, non-interest-bearing deposits, NOW accounts, and certificates of deposit have all decreased by \$838,000, \$4.4 million, and \$14.5 million, respectively, from December 31, 2011. Savings and money market accounts have increased \$6.7 million and \$8.3 million primarily as a result of transfers from other account types. The Bank currently does not have any outstanding brokered certificates of deposit.

Borrowed Funds

Borrowed funds decreased \$5.9 million during the first nine months of 2012. The majority of this decrease is the result of \$5.0 million of FHLB advances maturing during the first nine months. The Bank's current strategy for borrowings is to consider replacing any maturities with five to ten year term borrowings due to the current interest rate environment, while considering loan and investment opportunities. Term loan maturities of \$5.0 million in 2012 were not replaced due to excess cash on hand and limited investment and loan opportunities. The Company's daily cash requirements or short-term investments are primarily met by using the financial instruments available through the Federal Home Loan Bank of Pittsburgh.

In December 2003, the Company formed a special purpose entity; Citizens Financial Statutory Trust I (“the Entity”), to issue \$7,500,000 of floating rate obligated mandatory redeemable securities as part of a pooled offering. The rate is determined quarterly based on the 3 month LIBOR plus 2.80%. The Entity may redeem them, in whole or in part, at face value at any time. The Company borrowed the proceeds of the issuance from the Entity in December 2003 in the form of a \$7,500,000 note payable, which is included within “Borrowed Funds” in the liabilities section of the Company’s balance sheet. 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.

In December, 2008, the Company entered into an interest rate swap agreement to convert the above mentioned floating-rate debt to fixed rate debt on a notional amount of \$7.5 million. The interest rate swap instrument involves an agreement to receive a floating rate and pay a fixed rate, at specified intervals, calculated on the agreed-upon notional amount. The differentials paid or received on interest rate swap agreements are recognized as adjustments to interest expense in the period. The interest rate swap agreement was entered into on December 17, 2008 and expires December 17, 2013. The fair value of the interest rate swap at September 30, 2012 was a liability of \$251,000 and is included within other liabilities on the Consolidated Balance Sheet.

Stockholder’s Equity

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

Total stockholders’ equity was \$90.0 million at September 30, 2012 compared to \$81.5 million at December 31, 2011, an increase of \$8.5 million or 10.4%. Excluding accumulated other comprehensive income, stockholder’s equity increased \$7.5 million, or 9.8%. In the first nine months of 2012, the Company had net income of \$10.7 million and paid dividends of \$2.6 million, representing a cash dividend payout ratio of 24.5%. We also issued a one percent stock dividend to the Company’s shareholders, which had a market value of \$1.1 million at its issuance. When combined, the cash and stock dividends represent 35.1% of the Company’s net income through September 30, 2012. The Company purchased 16,931 shares of treasury stock at a weighted average cost of \$37.82 per share and 3,808 shares awarded as part of the restricted stock plan at a weighted average cost of \$37.10.

All of the Company’s investment securities are classified as available-for-sale, making this portion of the Company’s balance sheet more sensitive to the changing market value of investments. Accumulated other comprehensive income increased \$1.0 million from December 31, 2011 as a result of market value fluctuations.

The Company has also complied with standards of being well capitalized mandated by the banking regulators. The Company’s primary regulators have established “risk-based” capital requirements designed to measure capital adequacy. Risk-based capital ratios reflect the relative risks associated with various assets entities hold in their portfolios. A weight category of 0% (lowest risk assets), 20%, 50%, or 100% (highest risk assets), is assigned to each asset on the balance sheet. The Company is currently reviewing the potential impact of changes to the “risk based” capital requirements that have been proposed that are known as BASEL III. The Company’s computed risk-based capital ratios are as follows (dollars in thousands):

| | September 30, 2012 | | December 31, 2011 | |
|---|-----------------------|--------|----------------------|--------|
| Total capital (to risk-weighted assets) | Amount | Ratio | Amount | Ratio |
| Company | \$ 89,810 | 17.70% | \$ 82,050 | 16.23% |
| For capital adequacy purposes | 40,595 | 8.00% | 40,432 | 8.00% |
| To be well capitalized | 50,744 | 10.00% | 50,540 | 10.00% |
| Tier I capital (to risk-weighted assets) | | | | |
| Company | \$ 83,253 | 16.41% | \$ 75,541 | 14.95% |
| For capital adequacy purposes | 20,297 | 4.00% | 20,216 | 4.00% |
| To be well capitalized | 30,446 | 6.00% | 30,324 | 6.00% |
| Tier I capital (to average assets) | | | | |
| Company | \$ 83,253 | 9.62% | \$ 75,541 | 8.83% |
| For capital adequacy purposes | 34,619 | 4.00% | 34,223 | 4.00% |
| To be well capitalized | 43,274 | 5.00% | 42,779 | 5.00% |

The Bank's computed risk-based capital ratios are as follows (dollars in thousands):

| | September 30, 2012 | | December 31, 2011 | |
|---|-----------------------|--------|----------------------|--------|
| Total capital (to risk-weighted assets) | Amount | Ratio | Amount | Ratio |
| Bank | \$ 85,393 | 16.89% | \$ 77,051 | 15.29% |
| For capital adequacy purposes | 40,450 | 8.00% | 40,326 | 8.00% |
| To be well capitalized | 50,562 | 10.00% | 50,408 | 10.00% |
| Tier I capital (to risk-weighted assets) | | | | |
| Bank | \$ 79,066 | 15.64% | \$ 70,729 | 14.03% |
| For capital adequacy purposes | 20,225 | 4.00% | 20,163 | 4.00% |
| To be well capitalized | 30,337 | 6.00% | 30,245 | 6.00% |
| Tier I capital (to average assets) | | | | |
| Bank | \$ 79,066 | 9.15% | \$ 70,729 | 8.28% |
| For capital adequacy purposes | 34,565 | 4.00% | 34,166 | 4.00% |
| To be well capitalized | 43,206 | 5.00% | 42,708 | 5.00% |

Off Balance Sheet Activities

Some financial instruments, such as loan commitments, credit lines, and letters of credit are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at September 30, 2012 (in thousands):

| | |
|------------------------------|----------|
| Commitments to extend credit | \$76,921 |
| Standby letters of credit | 5,205 |
| | \$82,126 |

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing for personal. Effective in the third quarter of 2010, overdraft charges as a result of ATM withdrawals and one time point of sale (non-recurring) transactions require prior approval of the customer. The non-contractual amount of financial instruments with off-balance sheet risk at September 30, 2012 was \$12,637,000. The Company reserves the right to discontinue this service without prior notice.

Liquidity

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

Cash generated by operating activities, investing activities and financing activities influences liquidity management. Our Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows. The most important source of funds is the deposits that are primarily core. Repayment of principal on outstanding loans and cash flows created from the investment portfolio also a factor in liquidity management. Other sources of funding include brokered certificates of deposit and the sale of loans or investments, 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 presented. Other significant uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures, including those for potential future branches during the first nine months of 2012 were \$179,000, compared to \$643,000 during the same time period in 2011. The acquisition of land for possible future expansion accounted for most of the expenditure in 2011.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short-term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$244.3 million, of which \$31.3 million was outstanding at September 30, 2012. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon. We also have a borrower in custody line with the Federal Reserve Bank of approximately \$14.1 million, which also is not drawn upon as of September 30, 2012. The Company continues to evaluate its liquidity needs and as necessary finds additional sources.

Citizens Financial is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial's primary source of income is dividends received from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. In particular, the Bank may not, as a state-chartered bank which is a member of the Federal Reserve System, declare a dividend without approval of the Federal Reserve, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At September 30, 2012, Citizens Financial had liquid assets of \$3.0 million.

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 our Company has no trading portfolio, it is not subject to trading risk.

Currently, our Company has equity securities that represent only .4% of our investment portfolio and, therefore, equity risk is not significant.

The primary components of interest-sensitive assets include adjustable-rate loans and investments, loan repayments, investment maturities and money market investments. The primary components of interest-sensitive liabilities include maturing certificates of deposit, IRA certificates of deposit 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 accounts which are paid current market interest rates).

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 our Company's net interest income because the re-pricing of certain assets and liabilities is discretionary and is subject to competitive 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. We have not experienced the kind of earnings volatility that might be indicated from gap analysis.

Our 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 our Company's risk exposure.

We use numerous interest rate simulations employing a variety of assumptions to evaluate our interest rate risk exposure. Various analysis performed in the third quarter ranging from a decrease in interest rates of 100 basis points to an increase in interest rates of 500 basis points have resulted in variances over the next twelve to twenty four months that are within policy limits set by the Company's Board of Directors.

Item 3-Quantitative and Qualitative Disclosure about Market Risk

In the normal course of conducting business activities, the Company is exposed to market risk, principally interest rate risk, through the operations of its banking subsidiary. Interest rate risk arises from market driven fluctuations in interest rates that affect cash flows, income, expense and values of financial instruments and was discussed previously in this Form 10-Q. Management and a committee of the Board of Directors manage interest rate risk (see also "Interest Rate and Market Risk Management").

No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the SEC Form 10-K for the period ended December 31, 2011.

Item 4-Control and Procedures

(a) Disclosure Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the SEC (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes to Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended

September 30, 2012 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

Management is not aware of any litigation that would have a material adverse effect on the consolidated financial position of the Company. Any pending proceedings are ordinary, routine litigation incidental to the business of the Company and its subsidiary. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Company and its subsidiary by government authorities.

Item 1A – Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1.A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition or future results. At September 30, 2012 the risk factors of the Company have not changed materially from those reported in our Annual Report on Form 10-K. However, the risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares (or units Purchased) | Average Price Paid per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1) |
|----------------------|---|---|---|--|
| 7/1/12 to 7/30/12 | - | - | - | 139,034 |
| 8/1/12 to 8/31/12 | 3,350 | \$43.30 | 3,350 | 135,684 |
| 9/1/12 to 9/30/12 | - | - | - | 135,684 |
| Total | 3,350 | \$43.30 | 3,350 | 135,684 |

(1) On January 17, 2012, the Company announced that the Board of Directors authorized the Company to repurchase up to an additional 140,000 shares. The repurchases will be conducted through open-market purchases or privately negotiated transactions and will be made from time to time depending on market conditions and other factors. No time limit was placed on the duration of the share repurchase program. Any repurchased shares will

be held as treasury stock and will be available for general corporate purposes.

Item 3 - Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosure

Not applicable.

Item 5 - Other Information

None

51

Item 6 - Exhibits

(a) The following documents are filed as a part of this report:

- 3.1 Articles of Incorporation of Citizens Financial Services, Inc., as amended (1)
- 3.2 Bylaws of Citizens Financial Services, Inc.(2)
- 4.1 Instrument defining the rights of security holders.(3)
- 4.2 No long term debt instrument issued by the Company exceeds 10% of consolidated assets or is registered. In accordance with paragraph 4(iii) of Item 601(b) of Regulation S-K, the Company will furnish the Securities and Exchange Commission copies of long-term debt instruments and related agreements upon request.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer
- 101 The following materials from the Company's Quarterly Report on Form 10-Q for the period ended September
- ** 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) The Consolidated Balance Sheet (unaudited), (ii) the Consolidated Statement of Income (unaudited), (iii) the Consolidated Statement of Comprehensive Income (unaudited), (iv) the Consolidated Statement of Cash Flows (unaudited) and (v) related notes (unaudited).

(1) Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2010, as filed with the Commission on May 12, 2010.

(2) Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K, as filed with the Commission on December 24, 2009.

(3) Incorporated by reference to Exhibit 4 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the Commission on March 14, 2006.

** Furnished, not filed.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the undersigned Registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

Citizens Financial Services, Inc.

November 8, 2012

By: /s/ Randall E. Black
Randall E. Black
President and Chief Executive
Officer
(Principal Executive Officer)

November 8, 2012

By: /s/ Mickey L. Jones
Mickey L. Jones
Chief Financial Officer
(Principal Accounting Officer)

