CITIZENS FINANCIAL SERVICES INC
Form 10-Q
November 07, 2013

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

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

For the quarterly period ended September 30, 2013
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	23-2265045
(State or other jurisdiction of incorporation or organization)	(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 __X__ 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 __X__ 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.

Large accelerated filer ____ Accelerated filer _X__

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 __X__

The number of outstanding shares of the Registrant's Common Stock, as of October 29, 2013, was 3,019,354.

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

(in thousands except share data)	September 30 2013	December 31 2012
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	$ 10,956	$ 12,307
Interest-bearing	2,800	14,026
Total cash and cash equivalents	13,756	26,333
Interest bearing time deposits with other banks	2,480	-
Available-for-sale securities	318,452	310,252
Loans held for sale	260	1,458
Loans (net of allowance for loan losses: 2013, $7,070 and 2012, $6,784)	515,262	495,679
Premises and equipment	11,259	11,521
Accrued interest receivable	3,815	3,816
Goodwill	10,256	10,256
Bank owned life insurance	14,554	14,177
Other assets	9,302	8,935
TOTAL ASSETS	$ 899,396	$ 882,427
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 89,716	$ 89,494
Interest-bearing	668,940	647,602
Total deposits	758,656	737,096
Borrowed funds	43,163	46,126
Accrued interest payable	971	1,143
Other liabilities	6,226	8,587
TOTAL LIABILITIES	809,016	792,952
STOCKHOLDERS' EQUITY:		
Preferred Stock $1.00 par value; authorized 3,000,000 shares September 30, 2013 and December 31, 2012; none issued in 2013 or 2012	-	-
Common stock $1.00 par value; authorized 15,000,000 shares; issued 3,305,517 at September 30, 2013 and 3,161,324 at December 31, 2012	3,306	3,161
Additional paid-in capital	23,545	16,468
Retained earnings	72,190	71,813
Accumulated other comprehensive (loss) income	(816)	4,631

Treasury stock, at cost: 289,040 shares at September 30, 2013				
and 262,921 shares at December 31, 2012		(7,845)		(6,598)
TOTAL STOCKHOLDERS' EQUITY		90,380		89,475
TOTAL LIABILITIES AND				
STOCKHOLDERS' EQUITY	$	899,396	$	882,427

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

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

(in thousands, except per share data)	Three Months Ended September 30 2013	Three Months Ended September 30 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
INTEREST INCOME:				
Interest and fees on loans	$ 7,521	$ 7,448	$ 21,799	$ 22,352
Interest-bearing deposits with banks	8	5	27	11
Investment securities:				
Taxable	905	1,085	2,804	3,519
Nontaxable	850	919	2,563	2,793
Dividends	23	17	61	49
TOTAL INTEREST INCOME	9,307	9,474	27,254	28,724
INTEREST EXPENSE:				
Deposits	1,279	1,486	3,894	4,707
Borrowed funds	283	373	951	1,179
TOTAL INTEREST EXPENSE	1,562	1,859	4,845	5,886
NET INTEREST INCOME	7,745	7,615	22,409	22,838
Provision for loan losses	90	105	315	315
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	7,655	7,510	22,094	22,523
NON-INTEREST INCOME:				
Service charges	1,100	1,139	3,203	3,346
Trust	169	148	539	472
Brokerage and insurance	120	80	333	305
Investment securities gains, net	91	240	385	561
Gains on loans sold	75	102	236	287
Earnings on bank owned life insurance	127	128	377	378
Other	124	109	328	342
TOTAL NON-INTEREST INCOME	1,806	1,946	5,401	5,691
NON-INTEREST EXPENSES:				
Salaries and employee benefits	2,856	2,705	8,456	8,126
Occupancy	302	304	956	928
Furniture and equipment	157	113	372	315
Professional fees	187	209	604	701
FDIC insurance	112	115	337	353
Pennsylvania shares tax	183	115	548	441
Other	1,123	1,398	3,301	3,488
TOTAL NON-INTEREST EXPENSES	4,920	4,959	14,574	14,352
	4,541	4,497	12,921	13,862

Income before provision for income taxes								
Provision for income taxes		1,029		1,033		2,842		3,196
NET INCOME	$	3,512	$	3,464	$	10,079	$	10,666
PER COMMON SHARE DATA:								
Net Income - Basic	$	1.16	$	1.13	$	3.33	$	3.49
Net Income - Diluted	$	1.16	$	1.13	$	3.33	$	3.48
Cash Dividends Paid	$	0.285	$	0.290	$	0.837	$	0.853

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

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

(in thousands)	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Net income	$ 3,512	$ 3,464	$ 10,079	$ 10,666
Other comprehensive income (loss):				
Change in unrealized gains on available for sale securities	(183)	1,724	(8,215)	2,041
Income tax effect	62	(587)	2,793	(694)
Change in unrecognized pension cost	66	-	194	-
Income tax effect	(22)	-	(66)	-
Change in unrealized loss on interest rate swap	53	32	154	97
Income tax effect	(18)	(11)	(52)	(33)
Less: Reclassification adjustment for investment security gains included in net income	(91)	(240)	(385)	(561)
Income tax effect	30	82	130	191
Other comprehensive income (loss), net of tax	(103)	1,000	(5,447)	1,041
Comprehensive income	$ 3,409	$ 4,464	$ 4,632	$ 11,707

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

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

	Nine Months Ended September 30,	
(in thousands)	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 10,079	$ 10,666
Adjustments to reconcile net income to net		
cash provided by operating activities:		
Provision for loan losses	315	315
Depreciation and amortization	318	311
Amortization and accretion of investment securities	1,837	1,782
Deferred income taxes	570	213
Investment securities gains, net	(385)	(561)
Earnings on bank owned life insurance	(377)	(378)
Originations of loans held for sale	(17,039)	(21,625)
Proceeds from sales of loans held for sale	18,473	21,912
Realized gains on loans sold	(236)	(287)
Decrease (increase) in accrued interest receivable	1	(340)
Decrease in accrued interest payable	(172)	(299)
Other, net	(495)	(941)
Net cash provided by operating activities	12,889	10,768
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from sales	15,894	18,363
Proceeds from maturity and principal repayments	64,380	86,565
Purchase of securities	(98,526)	(109,289)
Purchase of interest bearing time deposits with other banks	(2,480)	-
Proceeds from redemption of regulatory stock	1,186	646
Purchase of regulatory stock	(563)	(1,405)
Net increase in loans	(19,800)	(11,736)
Purchase of premises, equipment and software	(339)	(179)
	151	650

Proceeds from sale of foreclosed assets held for sale		
Net cash used in investing activities	(40,097)	(16,385)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	21,560	(4,786)
Repayments of long-term borrowings	(10,800)	(5,627)
Net increase (decrease) in short-term borrowed funds	7,837	(299)
Purchase of treasury and restricted stock	(1,431)	(782)
Dividends paid	(2,535)	(2,611)
Net cash provided (used) by financing activities	14,631	(14,105)
Net decrease in cash and cash equivalents	(12,577)	(19,722)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	26,333	30,432
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 13,756	$ 10,710
Supplemental Disclosures of Cash Flow Information:		
Interest paid	$ 5,017	$ 6,185
Income taxes paid	$ 2,945	$ 3,395
Loans transferred to foreclosed property	$ 62	$ 123
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").

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, 2013 and 2012 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, 2013 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, 2012.

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,	
	2013	2012	2013	2012
Net income applicable to common stock	$3,512,000	$3,464,000	$10,079,000	$10,666,000
Basic earnings per share computation				
Weighted average common shares outstanding	3,024,507	3,052,628	3,029,801	3,059,808
Earnings per share - basic	$1.16	$1.13	$3.33	$3.49
Diluted earnings per share computation				
Weighted average common shares outstanding for basic earnings per share	3,024,507	3,052,628	3,029,801	3,059,808
Add: Dilutive effects of restricted stock	1,483	2,066	1,288	1,762

Weighted average common shares outstanding for dilutive earnings per share	3,025,990	3,054,694	3,031,089	3,061,570
Earnings per share - diluted	$1.16	$1.13	$3.33	$3.48

For the three months ended September 30, 2013 and 2012, there were 1,037 and 0 shares, respectively, related to the restricted stock program that were excluded from the diluted earnings per share calculations since they were anti-dilutive. For the nine months ended September 30, 2013 and 2012, 3,280 and 3,419 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, 2013 and December 31, 2012 were as follows (in thousands):

September 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. agency securities	$ 146,649	$ 890	$ (1,607)	$ 145,932
U.S. treasury securities	11,850	-	(370)	11,480
Obligations of state and political subdivisions	95,608	2,594	(1,038)	97,164
Corporate obligations	20,039	346	(476)	19,909
Mortgage-backed securities in government sponsored entities	41,869	789	(190)	42,468
Equity securities in financial institutions	803	696	-	1,499
Total available-for-sale securities	$ 316,818	$ 5,315	$ (3,681)	$ 318,452
December 31, 2012				
Available-for-sale securities:				
U.S. agency securities	$ 125,125	$ 2,150	$ (41)	$ 127,234
U.S. treasury securities	4,922	25	-	4,947
Obligations of state and political subdivisions	95,288	5,721	(134)	100,875
Corporate obligations	21,699	452	(42)	22,109
Mortgage-backed securities in government sponsored entities	52,072	1,728	(127)	53,673
Equity securities in financial institutions	912	502	-	1,414
Total available-for-sale securities	$ 300,018	$ 10,578	$ (344)	$ 310,252

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, which individual securities have been in a continuous unrealized loss position, at September 30, 2013 and December 31, 2012 (in thousands). As of September 30, 2013, the Company owned 75 securities whose fair value was less than their cost basis.

September 30, 2013	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	$ 80,162	$ (1,607)	$ -	$ -	$ 80,162	$ (1,607)
U.S. treasury securities	11,480	(370)	-	-	11,480	(370)
Obligations of state and political subdivisions	20,396	(978)	1,642	(60)	22,038	(1,038)
Corporate obligations	12,009	(476)	-	-	12,009	(476)
Mortgage-backed securities in government sponsored entities	14,672	(176)	827	(14)	15,499	(190)
Total securities	$ 138,719	$ (3,607)	$ 2,469	$ (74)	$ 141,188	$ (3,681)
December 31, 2012						
U.S. agency securities	$ 6,016	$ (41)	$ -	$ -	$ 6,016	$ (41)
Obligations of states and political subdivisions	7,981	(134)	-	-	7,981	(134)
Corporate obligations	10,972	(42)	-	-	10,972	(42)
Mortgage-backed securities in government sponsored entities	8,651	(127)	-	-	8,651	(127)
Total securities	$ 33,620	$ (344)	$ -	$ -	$ 33,620	$ (344)

As of September 30, 2013, 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, U.S treasuries, obligations of states and political subdivisions, corporate obligations and mortgage backed securities in government sponsored entities. 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, 2013 and 2012 were $15,894,000 and $18,363,000, respectively. For the three months ended September 30, 2013 and 2012, there were sales of $121,000 and $1,709,000, respectively, of available-for-sale securities. The gross gains and losses were as follows (in thousands):

	Three Months Ended September30, 2013	Three Months Ended September30, 2012	Nine Months Ended September30, 2013	Nine Months Ended September30, 2012
Gross gains	$ 91	$ 240	$ 525	$ 561
Gross losses	-	-	(140)	-
Net gains	$ 91	$ 240	$ 385	$ 561

Investment securities with an approximate carrying value of $205.6 million and $193.3 million at September 30, 2013 and December 31, 2012, 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, 2013, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Fair Value
Available-for-sale debt securities:		
Due in one year or less	$ 12,531	$ 12,626
Due after one year through five years	104,250	104,486
Due after five years through ten years	84,875	84,107
Due after ten years	114,359	115,734
Total	$ 316,015	$ 316,953

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, 2013 and December 31, 2012, 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, 2013 and December 31, 2012 (in thousands):

September 30, 2013	Total Loans	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate loans:			
Residential	$ 183,370	$ 482	$ 182,888
Commercial and agricultural	196,446	8,594	187,852
Construction	18,272	-	18,272
Consumer	9,979	15	9,964
Other commercial and agricultural loans	54,160	1,795	52,365
State and political subdivision loans	60,105	-	60,105
Total	522,332	$ 10,886	$ 511,446

Allowance for loan losses		7,070
Net loans	$	515,262

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December 31, 2012	Total Loans	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate loans:			
Residential	$ 178,080	$ 424	$ 177,656
Commercial and agricultural	194,725	9,093	185,632
Construction	12,011	-	12,011
Consumer	10,559	-	10,559
Other commercial and agricultural loans	47,880	901	46,979
State and political subdivision loans	59,208	-	59,208
Total	502,463	$ 10,418	$ 492,045
Allowance for loan losses	6,784		
Net loans	$ 495,679		

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 equity loans 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 or if the loan is modified in a troubled debt restructuring. In addition, certain residential mortgages, home equity and consumer loans that are cross collateralized with commercial relationships that are determined to be impaired may also be classified as impaired. Impaired 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):

September 30, 2013	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
Real estate loans:					
Mortgages	$ 375	$ 141	$ 206	$ 347	$ 24
Home Equity	135	-	135	135	13
Commercial	10,052	5,714	2,880	8,594	560
Agricultural	-	-	-	-	-
Construction	-	-	-	-	-
Consumer	15	15	-	15	-
Other commercial loans	1,851	1,438	357	1,795	1
Other agricultural loans	-	-	-	-	-
State and political subdivision loans	-	-	-	-	-
Total	$ 12,428	$ 7,308	$ 3,578	$ 10,886	$ 598
December 31, 2012					
Real estate loans:					
Mortgages	$ 309	$ 150	$ 136	$ 286	$ 8
Home Equity	138	-	138	138	14
Commercial	10,669	6,476	2,617	9,093	559
Agricultural	-	-	-	-	-
Construction	-	-	-	-	-
Consumer	-	-	-	-	-
Other commercial loans	950	592	309	901	1
Other agricultural loans	-	-	-	-	-
State and political subdivision loans	-	-	-	-	-
Total	$ 12,066	$ 7,218	$ 3,200	$ 10,418	$ 582

The following table includes the average balance of impaired financing receivables by class and the income recognized on impaired loans for the three and nine month periods ended September 30, 2013 and 2012 (in thousands):

	For the Nine Months ended					
	September 30, 2013			September 30, 2012		
	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
Real estate loans:						
Mortgages	$ 336	$ 6	$ -	$ 139	$ 2	$ -
Home Equity	136	3	-	100	3	1
Commercial	8,521	426	361	7,891	74	45
Agricultural	-	-	-	-	-	-
Construction	-	-	-	-	-	-
Consumer	2	-	-	-	-	-
Other commercial loans	1,740	58	-	439	-	-
Other agricultural loans	-	-	-	-	-	-
State and political subdivision loans	-	-	-	-	-	-
Total	$ 10,735	$ 493	$ 361	$ 8,569	$ 79	$ 46

	For the Three Months Ended					
	September 30, 2013			September 30, 2012		
	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
Real estate loans:						
Mortgages	$ 349	$ 2	$ -	$ 253	$ 1	$ -
Home Equity	135	1	-	113	1	-
Commercial	8,372	342	326	7,398	35	22
Agricultural	-	-	-	-	-	-
Construction	-	-	-	-	-	-
Consumer	5	-	-	-	-	-
Other commercial loans	1,647	17	-	382	-	-
Other agricultural loans	-	-	-	-	-	-
State and political subdivision loans	-	-	-	-	-	-
Total	$ 10,508	$ 362	$ 326	$ 8,146	$ 37	$ 22

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, agricultural and municipal 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 55% (60% during 2012) 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, 2013 and December 31, 2012 (in thousands):

September 30, 2013	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	$ 150,711	$ 3,045	$ 21,566	$ 211	$ -	$ 175,533
Agricultural	15,054	3,845	2,014	-	-	20,913
Construction	18,272	-	-	-	-	18,272
Other commercial loans	40,948	1,526	2,398	8	-	44,880
Other agricultural loans	7,142	865	1,273	-	-	9,280
State and political subdivision loans	60,105	-	-	-	-	60,105
Total	$ 292,232	$ 9,281	$ 27,251	$ 219	$ -	$ 328,983
December 31, 2012						
Real estate loans:						
Commercial	$ 149,892	$ 7,616	$ 19,127	$ 75	$ -	$ 176,710
Agricultural	13,690	2,386	1,939	-	-	18,015
Construction	12,011	-	-	-	-	12,011
Other commercial loans	39,239	826	1,555	-	-	41,620
Other agricultural loans	4,833	589	838	-	-	6,260
State and political subdivision loans	58,120	-	1,088	-	-	59,208
Total	$ 277,785	$ 11,417	$ 24,547	$ 75	$ -	$ 313,824

For residential real estate mortgages, home equity 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, 2013 and December 31, 2012 (in thousands):

September 30, 2013	Performing	Non-performing	Total

Real estate loans:						
Mortgages	$	114,291	$	718	$	115,009
Home Equity		68,089		272		68,361
Consumer		9,964		15		9,979
Total	$	192,344	$	1,005	$	193,349
December 31, 2012						
Real estate loans:						
Mortgages	$	105,822	$	726	$	106,548
Home Equity		71,263		269		71,532
Consumer		10,555		4		10,559
Total	$	187,640	$	999	$	188,639

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, 2013 and December 31, 2012 (in thousands):

September 30, 2013	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total Financing Receivables	90 Days and Accruing
Real estate loans:							
Mortgages	$ 935	$ 140	$ 600	$ 1,675	$ 113,334	$ 115,009	$ 195
Home Equity	539	137	230	906	67,455	68,361	94
Commercial	1,186	283	3,019	4,488	171,045	175,533	299
Agricultural	125	-	-	125	20,788	20,913	-
Construction	-	-	-	-	18,272	18,272	-
Consumer	46	16	-	62	9,917	9,979	-
Other commercial loans	17	65	351	433	44,447	44,880	-
Other agricultural loans	-	-	-	-	9,280	9,280	-
State and political subdivision loans	-	-	-	-	60,105	60,105	-
Total	$ 2,848	$ 641	$ 4,200	$ 7,689	$ 514,643	$ 522,332	$ 588
Loans considered non-accrual	$ 127	$ 425	$ 3,612	$ 4,164	$ 4,533	$ 8,697	
Loans still accruing	2,721	216	588	3,525	510,110	513,635	
Total	$ 2,848	$ 641	$ 4,200	$ 7,689	$ 514,643	$ 522,332	

December 31, 2012							
Real estate loans:							
Mortgages	$ 636	$ 294	$ 493	$ 1,423	$ 105,125	$ 106,548	$ 244
Home Equity	267	17	222	506	71,026	71,532	88
Commercial	602	-	2,149	2,751	173,959	176,710	152
Agricultural	54	-	-	54	17,961	18,015	-
Construction	-	-	-	-	12,011	12,011	-
Consumer	45	43	4	92	10,467	10,559	4
	962	-	317	1,279	40,341	41,620	18

Other commercial loans							
Other agricultural loans	-	-	-	-	6,260	6,260	-
State and political subdivision loans	-	-	-	-	59,208	59,208	-
Total	$ 2,566	$ 354	$ 3,185	$ 6,105	$ 496,358	$ 502,463	$ 506
Loans considered non-accrual	$ 73	$ 69	$ 2,679	$ 2,821	$ 5,246	$ 8,067	
Loans still accruing	2,493	285	506	3,284	491,112	494,396	
Total	$ 2,566	$ 354	$ 3,185	$ 6,105	$ 496,358	$ 502,463	

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 non-accrual status as of September 30, 2013 and December 31, 2012, respectively. The balances are presented by class of financing receivable (in thousands):

	September 30, 2013	December 31, 2012
Real estate loans:		
Mortgages	$ 523	$ 482
Home Equity	178	181
Commercial	7,521	7,042
Agricultural	-	-
Construction	-	-
Consumer	15	-
Other commercial loans	460	362
Other agricultural loans	-	-
State and political subdivision	-	-
	$ 8,697	$ 8,067

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 TDRs, 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. As of September 30, 2013 and December 31, 2012, included within the allowance for loan losses are reserves of $80,800 and $14,000 respectively, that are associated with loans modified as TDRs.

There were no loan modifications that were considered TDRs during the three months ended September 30, 2013. Loan modifications that are considered TDRs completed during the nine months ended September 30, 2013 and 2012 and the three months ended September 30, 2012, were as follows (dollars in thousands):

For the Nine Months Ended September 30, 2013					
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:						
Mortgages	1	-	$ 72	$ -	$ 72	$ -
Commercial	-	2	-	1,365	-	1,365
Other commercial loans	-	2	-	1,530	-	1,530
Total	1	4	$ 72	$ 2,895	$ 72	$ 2,895

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	For the Three Months Ended September 30, 2012					
	Number of contracts		Pre-modification Outstanding Recorded Investment		Post-Modification Outstanding Recorded Investment	
	Interest Modification	Term Modification	Interest Modification	Term Modification	Interest Modification	Term 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 Modification	Term Modification	Interest Modification	Term Modification	Interest Modification	Term Modification
Real estate loans:						
Residential mortgage	1	1	$ 48	$ 71	$ 48	$ 71
Commercial	-	3	-	160	-	160
Total	1	4	$ 48	$ 231	$ 48	$ 231

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. The following table presents the recorded investment in loans that were modified as TDRs during each 12-month period prior to the current reporting periods, which begin January 1, 2013 and 2012 (nine month periods) and July 1, 2013 and 2012 (3 month periods), respectively, and that subsequently defaulted during these reporting periods (dollars in thousands):

	For the Three Months Ended				For the Nine Months Ended			
	September 30, 2013		September 30, 2012		September 30, 2013		September 30, 2012	
	Number of contracts	Recorded investment	Number of contracts	Recorded investment	Number of contracts	Recorded investment	Number of contracts	Recorded investment
Real estate loans:								
Commercial	-	$ -	-	$ -	-	$ -	1	$ 50
Total recidivism	-	$ -	-	$ -	-	$ -	1	$ 50

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, 2013 and December 31, 2012, respectively (in thousands):

September 30, 2013			December 31, 2012		
Individually evaluated for	Collectively evaluated for	Total	Individually evaluated for impairment	Collectively evaluated for	Total

	impairment	impairment		impairment		
Real estate loans:						
Residential	$ 37	$ 919	$ 956	$ 22	$ 853	$ 875
Commercial and agricultural	560	3,852	4,412	559	3,878	4,437
Construction	-	112	112	-	38	38
Consumer	-	114	114	-	119	119
Other commercial and agricultural loans	1	963	964	1	727	728
State and political subdivision loans	-	313	313	-	271	271
Unallocated	-	199	199	-	316	316
Total	$ 598	$ 6,472	$ 7,070	$ 582	$ 6,202	$ 6,784

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The following tables roll forward the balance of the ALLL by portfolio segment for the three and nine month periods ended September 30, 2013 and 2012, respectively (in thousands):

	Balance at June 30, 2013	Charge-offs	Recoveries	Provision	Balance at September 30, 2013
Real estate loans:					
Residential	$ 934	$ (2)	$ 1	$ 23	$ 956
Commercial and agricultural	4,240	-	-	172	4,412
Construction	91	-	-	21	112
Consumer	114	(12)	5	7	114
Other commercial and agricultural loans	957	(1)	-	8	964
State and political subdivision loans	310	-	-	3	313
Unallocated	343	-	-	(144)	199
Total	$ 6,989	$ (15)	$ 6	$ 90	$ 7,070

	Balance at December 31, 2012	Charge-offs	Recoveries	Provision	Balance at September 30, 2013
Real estate loans:					
Residential	$ 875	$ (15)	$ 3	$ 93	$ 956
Commercial and agricultural	4,437	-	-	(25)	4,412
Construction	38	-	-	74	112
Consumer	119	(42)	26	11	114
Other commercial and agricultural loans	728	(1)	-	237	964
State and political subdivision loans	271	-	-	42	313
Unallocated	316	-	-	(117)	199
Total	$ 6,784	$ (58)	$ 29	$ 315	$ 7,070

	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

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 TDRs 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. The following qualitative factors experienced changes during the first nine months of 2013:

- 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 Marcellus shale natural gas exploration activities.
- The qualitative factor for trends in volume, terms and nature of the loan portfolio was increased for commercial and agricultural real estate, other commercial and agricultural loans and state and political subdivision loan categories due to the increase of the number of loans that are participations that were purchased from other banks and

therefore subject to different underwriting standards.

- The qualitative factor for the existence and effect of any credit concentrations and changes in the level of such concentrations was increased for commercial and other loans as a result of growth in these segments and was lowered for commercial and agricultural real estate as the loan growth in these segments has slowed in 2013.

During the third quarter of 2013, there were no significant changes in any qualitative factor. As a result, the change in the allocation of the allowance from June 30, 2013, is mainly attributable to the changes in the loan portfolio balances since that date and the change in the loan grades. The increase in the allowance related to commercial and agricultural real estate in the third quarter was primarily the result of the increase during the period in substandard loans of $2.1 million dollars that were not individually evaluated for impairment.

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 livestock 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, which included a new lender and several lending support positions.

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, which included a new lender and several lending support positions.
- 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, 2013 and December 31, 2012, the Bank holds $2,667,200 and $3,290,000, 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 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) A significant 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. 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 during 2012 and 2013 and has reinstituted the dividend.

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 2012 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, 2013 and 2012, respectively (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Service cost	$ 81	$ 82	$ 258	$ 249
Interest cost	89	85	274	259
Expected return on plan assets	(165)	(139)	(508)	(425)
Net amortization and deferral	66	34	194	102
Net periodic benefit cost	$ 71	$ 62	$ 218	$ 185

The Company contributed $1,000,000 to the Pension Plan in 2013.

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 $193,000 and $184,000 for the nine months ended September 30, 2013 and 2012, respectively. For the three months ended September 30, 2013 and 2012, contributions by the Company totaled $45,000 and $52,000, 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, 2013 and December 31, 2012, an obligation of $976,000 and $1,001,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Amounts included in interest expense on the deferred amounts totaled $5,000 and $4,000 for each of the three months ended September 30, 2013 and 2012. For the nine months ended September 30, 2013 and 2012, amounts included in interest expense on the deferred amounts totaled $12,000 for both periods.

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. As of September 30, 2013, 67,756 shares remain available to be issued 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.

The following table details the vesting, awarding and forfeiting of restricted shares during 2013 and 2012:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Unvested Shares	Weighted Average Market Price	Unvested Shares	Weighted Average Market Price	Unvested Shares	Weighted Average Market Price	Unvested Shares	Weighted Average Market Price
Outstanding, beginning of period	7,466	$ 41.89	8,507	$ 35.16	8,646	$ 35.51	9,921	$ 29.37
Granted	-	-	-	-	3,027	48.21	3,808	37.10
Forfeited	-	-	-	-	(55)	37.10	-	-
Vested	-	-	-	-	(4,152)	33.26	(5,222)	25.59
Outstanding, end of period	7,466	$ 41.89	8,507	$ 35.16	7,466	$ 41.89	8,507	$ 35.16

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 $117,000 and $103,000 for the nine months ended September 30, 2013 and 2012, respectively. For the three months ended September 30, 2013 and 2012, compensation expense totaled $39,000 and $37,000, 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, 2013 and December 31, 2012, an obligation of $1,010,000 and $901,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Expenses related to this plan totaled $109,000 and $69,000 for the nine months ended September 30, 2013 and 2012, respectively. For the three months ended September 30, 2013 and 2012, expenses totaled $37,000 and $23,000, respectively.

Note 8 – Accumulated Comprehensive Income

The following tables present the changes in accumulated other comprehensive (loss) income by component net of tax for the three and nine months ended September 30, 2013:

	Three Months Ended September 30, 2013			
	Unrealized gain (loss) on available for sale securities (a)	Unrealized gain (loss) on interest rate swap (a)	Defined Benefit Pension Items (a)	Total
Balance as of June 30, 2013	$ 1,259	$ (65)	$ (1,907)	$ (713)
Other comprehensive income (loss) before reclassifications (net of tax)	(121)	35	-	(86)
Amounts reclassified from accumulated other comprehensive (loss) income (net of tax)	(61)	-	44	(17)
Net current period other comprehensive income (loss)	(182)	35	44	(103)
Balance as of September 30, 2013	$ 1,077	$ (30)	$ (1,863)	$ (816)

	Nine months Ended September 30, 2013			
	Unrealized gain (loss) on available for sale securities (a)	Unrealized gain (loss) on interest rate swap (a)	Defined Benefit Pension Items (a)	Total
Balance as of December 31, 2012	$ 6,754	$ (132)	$ (1,991)	$ 4,631
Other comprehensive income (loss) before reclassifications (net of tax)	(5,422)	102	-	(5,320)
Amounts reclassified from accumulated other comprehensive (loss) income (net of tax)	(255)	-	128	(127)
Net current period other comprehensive income (loss)	(5,677)	102	128	(5,447)
Balance as of September 30, 2013	$ 1,077	$ (30)	$ (1,863)	$ (816)

(a) Amounts in parentheses indicate debits

The following table presents the significant amounts reclassified out of each component of accumulated other comprehensive income for the three and nine months ended September 30, 2013:

Details about accumulated other comprehensive (loss) income	Amount reclassified from accumulated comprehensive (loss) income (a)	Affected line item in the statement where net Income is

	Three Months Ended	Nine Months Ended	presented
	September 30, 2013		
Unrealized gains and losses on available for sale securities			
	$ 91	$ 385	Investment securities gains, net
	(30)	(130)	Provision for income taxes
	$ 61	$ 255	Net of tax
Defined benefit pension items			
	$ (66)	$ (194)	Salaries and employee benefits
	22	66	Provision for income taxes
	$ (44)	$ (128)	Net of tax

(a) Amounts in parentheses indicate debits to profit/loss

Note 9 – 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.

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, 2013 and December 31, 2012 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, 2013	Level I	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Assets				
Securities available for sale:				
U.S. agency securities	$ -	$ 145,932	$ -	$ 145,932
U.S. treasury securities		11,480		11,480
Obligations of state and				
political subdivisions	-	97,164	-	97,164
Corporate obligations	-	19,909	-	19,909
Mortgage-backed securities in				
government sponsored entities	-	42,468	-	42,468
Equity securities in financial institutions	1,499	-	-	1,499
Liabilities				
Trust Preferred Interest Rate Swap	-	(46)	-	(46)
December 31, 2012				
Fair value measurements on a recurring basis:				
Assets				
Securities available for sale:				
U.S. agency securities	$ -	$ 127,234	$ -	$ 127,234
U.S. treasury securities	-	4,947	-	4,947
Obligations of state and				
political subdivisions	-	100,875	-	100,875
Corporate obligations	-	22,109	-	22,109
Mortgage-backed securities in				
government sponsored entities	-	53,673	-	53,673
	1,414	-	-	1,414

Equity securities in financial institutions					
Liabilities					
Trust Preferred Interest Rate Swap	-	(200)		-	(200)

Financial Instruments, Non-Financial Assets and Non-Financial Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain financial assets, financial liabilities, non-financial assets and non-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. 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 2013 and 2012 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.

- 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. Once a loan is identified as individually impaired, management measures impairment using one of several methods, including collateral value, liquidation value and discounted cash flows. 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 2 inputs based on observable market data or Level 3 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.

- Other Real Estate owned – Other real estate owned, which is obtained through the Bank's foreclosure process is valued utilizing the appraised collateral value. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. At the time the foreclosure is completed, the Company obtains an updated external appraisal.

Assets measured at fair value on a nonrecurring basis as of September 30, 2013 and December 31, 2012 are included in the table below (in thousands):

September 30, 2013	Level I	Level II	Level III	T otal
Impaired Loans	$ -	$ -	$ 10,288	$ 10,288
Other real estate owned	-	-	501	501
December 31, 2012				
Impaired Loans	$ -	$ -	$ 9,836	$ 9,836
Other real estate owned	-	-	616	616

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.

	Fair value as of September 30, 2013	December 31, 2012	Valuation Technique(s)	Unobservable input	Range
Impaired Loans	$ 4,470	$ 4,882	Discounted Cash Flows	Discount rates	0-7%
	5,818	4,954	Appraised Collateral Values	Discount for time since appraisal	0-20%
				Selling costs	0%-10%
				Holding period	0 - 18 months
Other real estate owned	501	616	Appraised Collateral Values	Discount for time since appraisal	0-20%
				Selling costs	0%-10%
				Holding period	0 - 18 months

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

September 30, 2013	Carrying Amount	Fair Value	Level I	Level II	Level III
Financial assets:					

Cash and due from banks	$ 13,756	$ 13,756	$ 13,756	$ -	$ -
Interest bearing time deposits with other banks	2,480	2,477			2,477
Available-for-sale securities	318,452	318,452	1,499	316,953	-
Loans held for sale	260	260	260		
Net loans	515,262	532,086	-	-	532,086
Bank owned life insurance	14,554	14,554	14,554	-	-
Regulatory stock	2,942	2,942	2,942	-	-
Accrued interest receivable	3,815	3,815	3,815	-	-
Financial liabilities:					
Deposits	$ 758,656	$ 761,221	$ 490,390	$ -	$ 270,831
Borrowed funds	43,163	40,023	-	40,023	-
Trust preferred interest rate swap	46	46	-	46	-
Accrued interest payable	971	971	971	-	-

December 31, 2012	Carrying Amount	Fair Value	Level I	Level II	Level III
Financial assets:					
Cash and due from banks	$ 26,333	$ 26,333	$ 26,333	$ -	$ -
Available-for-sale securities	310,252	310,252	1,414	308,838	-
Loans held for sale	1,458	1,458	1,458		
Net loans	495,679	522,502	-	-	522,502
Bank owned life insurance	14,177	14,177	14,177	-	-
Regulatory stock	3,565	3,565	3,565	-	-
Accrued interest receivable	3,816	3,816	3,816	-	-
Financial liabilities:					
Deposits	$ 737,096	$ 742,422	$ 462,557	$ -	$ 279,865
Borrowed funds	46,126	43,403	-	43,403	-
Trust preferred interest rate swap	200	200	-	200	-
Accrued interest payable	1,143	1,143	1,143	-	-

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.

Interest bearing time deposits with other banks:

The fair value of interest bearing time deposits with other banks 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.

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 held for sale

The carrying amount for loans held for sale approximates fair value as the loans are only held for less than a week from origination.

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 10 – Recent Accounting Pronouncements

In February 2013, the FASB issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendments in this Update require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles

(GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. For nonpublic entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2013. Early adoption is permitted. The expanded disclosures are presented in Note 8.

In July 2013, the FASB issued ASU 2013-10, Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes. The amendments in this Update permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. This Update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted.

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, 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 to implement 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 we have 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 2012 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 financial condition 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, 2013 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 20 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 loan production offices in Lock Haven and Dallas, 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. 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, 2013 and December 31, 2012, the Trust Department had $96.9 and $105.6 million of assets under management, respectively. The $8.7 million decrease is a result of net withdrawals of $13.4 million offset by increases in market value of trust assets.

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 Agency, Inc. 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 $92.0 million at December 31, 2012 to $99.9 million at September 30, 2013. 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 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. In addition to our knowledgeable employees, 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 $10,079,000 for the first nine months of 2013 compared to $10,666,000 for last year's comparable period, a decrease of $587,000 or 5.5%. Basic earnings per share for the first nine months of 2013 were $3.33, compared to $3.49 last year, representing a 4.6% decrease. Annualized return on assets and return on equity for the nine months of 2013 were 1.52% and 15.13%, respectively, compared with 1.62% and 17.74% for last year's comparable period.

Net income for the three months ended September 30, 2013 was $3,512,000 compared to $3,464,000 in the comparable 2012 period, an increase of $48,000 or 1.4%. Basic earnings per share for the three months ended September 30, 2013 were $1.16, compared to $1.13 last year, representing a 2.7% increase. Annualized return on assets and return on equity for the quarter ended September 30, 2013 was 1.58% and 15.42%, respectively, compared with 1.58% and 16.78% for the same 2012 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 2013 was $22,409,000, a decrease of $429,000, or 1.9%, compared to the same period in 2012. For each of the first nine months of 2013 and 2012, the provision for loan losses totaled

$315,000. Consequently, net interest income after the provision for loan losses was $22,094,000 compared to $22,523,000 during the first nine months of 2012.

For the three months ended September 30, 2013, net interest income was $7,745,000 compared to $7,615,000, an increase of $130,000, or 1.7% over the comparable period in 2012. During the third quarter of 2013, the Bank received a payoff of a non-accrual loan, which resulted in the recognition of $304,000 of non-accrual interest income. The provision for loan losses this quarter was $90,000 compared to $105,000 for last year's third quarter. Consequently, net interest income after the provision for loan losses was $7,655,000 for the quarter ended September 30, 2013 compared to $7,510,000 in 2012.

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, 2013 and 2012 on a tax equivalent basis (dollars in thousands):

Analysis of Average Balances and Interest Rates (1)
Nine Months Ended

	September 30, 2013			September 30, 2012		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
	$	$	%	$	$	%
ASSETS						
Short-term investments:						
Interest-bearing deposits at banks	18,113	25	0.18	11,844	11	0.13
Total short-term investments	18,113	25	0.18	11,844	11	0.13
Interest bearing time deposits at banks	157	2	2.02	-	-	-
Investment securities:						
Taxable	213,367	2,865	1.79	231,622	3,568	2.05
Tax-exempt (3)	92,200	3,883	5.62	94,235	4,232	5.99
Total investment securities	305,567	6,748	2.94	325,857	7,800	3.19
Loans:						
Residential mortgage loans	180,528	8,214	6.08	184,049	8,896	6.46
Construction	13,557	506	4.99	9,870	421	5.70
Commercial & agricultural loans	249,105	11,128	5.97	234,250	10,998	6.27
Loans to state & political subdivisions	59,394	1,975	4.45	56,766	2,004	4.72
Other loans	9,861	606	8.22	10,337	652	8.43
Loans, net of discount (2)(3)(4)	512,445	22,429	5.85	495,272	22,971	6.20
Total interest-earning assets	836,282	29,204	4.67	832,973	30,782	4.94
Cash and due from banks	3,748			3,698		
Bank premises and equipment	11,432			11,578		
Other assets	30,448			30,952		
Total non-interest earning assets	45,628			46,228		
Total assets	881,910			879,201		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
NOW accounts	207,003	586	0.38	200,296	602	0.40
Savings accounts	91,727	113	0.16	83,653	123	0.20

Money market accounts	85,641	303	0.47	71,126	228	0.43
Certificates of deposit	272,930	2,892	1.42	294,548	3,754	1.70
Total interest-bearing deposits	657,301	3,894	0.79	649,623	4,707	0.97
Other borrowed funds	40,391	951	3.15	54,315	1,179	2.90
Total interest-bearing liabilities	697,692	4,845	0.93	703,938	5,886	1.12
Demand deposits	87,379			85,571		
Other liabilities	8,039			9,526		
Total non-interest-bearing liabilities	95,418			95,097		
Stockholders' equity	88,800			80,166		
Total liabilities & stockholders' equity	881,910			879,201		
Net interest income		24,359			24,896	
Net interest spread (5)			3.74%			3.82%
Net interest income as a percentage of average interest-earning assets			3.89%			3.99%
Ratio of interest-earning assets to interest-bearing liabilities			120%			118%

(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, 2013			September 30, 2012		
Average Balance (1)	Interest	Average Rate	Average		Average