CITIZENS FINANCIAL SERVICES INC
Form 10-Q
November 14, 2011

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, 2011
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 ____

Non-accelerated filer ____ Smaller reporting company __X__
(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 November 1, 2011, was 2,908,657.

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

(in thousands except share data)	September 30 2011	December 31 2010
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	$ 10,761	$ 9,541
Interest-bearing	24,050	34,454
Total cash and cash equivalents	34,811	43,995
Available-for-sale securities	303,239	251,303
Loans (net of allowance for loan losses: 2011, $6,323 and 2010, $5,915)	472,289	467,602
Premises and equipment	11,819	12,503
Accrued interest receivable	3,980	3,455
Goodwill	10,256	10,256
Bank owned life insurance	13,542	13,171
Other assets	9,252	10,241
TOTAL ASSETS	$ 859,188	$ 812,526
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 80,557	$ 75,589
Interest-bearing	638,988	605,122
Total deposits	719,545	680,711
Borrowed funds	52,845	55,996
Accrued interest payable	1,539	1,779
Other liabilities	6,397	5,350
TOTAL LIABILITIES	780,326	743,836
STOCKHOLDERS' EQUITY:		
Preferred Stock		
$1.00 par value; authorized 3,000,000 shares September 30, 2011 and December 31, 2010; none issued in 2011 or 2010	-	-
Common stock		
$1.00 par value; authorized 15,000,000 shares; issued 3,132,866 at September 30, 2011 and 3,104,434 shares at December 31, 2010	3,133	3,104
Additional paid-in capital	15,320	14,235
Retained earnings	60,936	54,932
Accumulated other comprehensive income	4,533	1,054
Treasury stock, at cost: 224,209 shares at September 30, 2011 and 212,067 shares at December 31, 2010	(5,060)	(4,635)

TOTAL STOCKHOLDERS' EQUITY		78,862		68,690
TOTAL LIABILITIES AND				
STOCKHOLDERS' EQUITY	$	859,188	$	812,526

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

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

	Three Months Ended September 30		Nine months Ended September 30	
(in thousands, except share and per share data)	2011	2010	2011	2010
INTEREST INCOME:				
Interest and fees on loans	$ 7,555	$ 7,782	$ 22,413	$ 23,268
Interest-bearing deposits with banks	22	24	64	55
Investment securities:				
Taxable	1,095	1,178	3,443	3,777
Nontaxable	931	772	2,688	2,140
Dividends	10	14	39	27
TOTAL INTEREST INCOME	9,613	9,770	28,647	29,267
INTEREST EXPENSE:				
Deposits	1,969	2,313	6,103	7,374
Borrowed funds	437	444	1,325	1,324
TOTAL INTEREST EXPENSE	2,406	2,757	7,428	8,698
NET INTEREST INCOME	7,207	7,013	21,219	20,569
Provision for loan losses	150	300	525	840
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	7,057	6,713	20,694	19,729
NON-INTEREST INCOME:				
Service charges	1,059	919	2,902	2,709
Trust	163	130	466	411
Brokerage and insurance	79	91	297	314
Investment securities gains, net	117	-	351	99
Realized gains on loans sold	36	44	111	92
Earnings on bank owned life insurance	126	127	371	376
Other	149	134	418	358
TOTAL NON-INTEREST INCOME	1,729	1,445	4,916	4,359
NON-INTEREST EXPENSES:				
Salaries and employee benefits	2,527	2,436	7,560	7,293
Occupancy	295	295	1,014	898
Furniture and equipment	115	114	338	331
Professional fees	197	176	526	509
FDIC insurance	47	245	547	699
Other	1,218	1,220	3,674	3,440
TOTAL NON-INTEREST EXPENSES	4,399	4,486	13,659	13,170
Income before provision for income taxes	4,387	3,672	11,951	10,918

Provision for income taxes	1,009	775	2,596	2,348
NET INCOME	$ 3,378	$ 2,897	$ 9,355	$ 8,570
Earnings Per Share	$ 1.16	$ 0.99	$ 3.21	$ 2.93
Cash Dividends Per Share	$ 0.265	$ 0.255	$ 0.790	$ 0.760
Weighted average number of shares outstanding	2,917,158	2,920,307	2,916,739	2,924,746

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

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

(in thousands)	Three Months Ended September 30, 2011	2010	Nine months Ended September 30, 2011	2010
Net income	$ 3,378	$ 2,897	$ 9,355	$ 8,570
Other comprehensive income:				
Change in unrealized gains on available for sale securities	2,077	1,429	5,628	3,398
Change in unrealized loss on interest rate swap	(7)	(108)	(6)	(355)
Less: Reclassification adjustment for gain included in net income	(117)	-	(351)	(99)
Other comprehensive income, before tax	1,953	1,321	5,271	2,944
Income tax expense related to other comprehensive income	664	449	1,792	1,001
Other comprehensive income, net of tax	1,289	872	3,479	1,943
Comprehensive income	$ 4,667	$ 3,769	$ 12,834	$ 10,513

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

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

(in thousands)	Nine months Ended September 30, 2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 9,355	$ 8,570
Adjustments to reconcile net income to net		
cash provided by operating activities:		
Provision for loan losses	525	840
Depreciation and amortization	394	362
Amortization and accretion of investment securities	1,455	561
Deferred income taxes	260	49
Investment securities gains, net	(351)	(99)
Earnings on bank owned life insurance	(371)	(376)
Loss (gain) on sale of foreclosed assets held for sale	43	(48)
Originations of loans held for sale	(7,470)	(6,607)
Proceeds from sales of loans held for sale	7,581	6,699
Realized gains on loans sold	(111)	(92)
Increase in accrued interest receivable	(525)	(495)
Decrease in accrued interest payable	(240)	(223)
Other, net	338	(748)
Net cash provided by operating activities	10,883	8,393
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from sales of available-for-sale securities	9,790	8,871
Proceeds from maturity and principal repayments of securities	61,896	35,728
Purchase of securities	(119,451)	(73,674)
Proceeds from redemption of regulatory stock	312	-
Net increase in loans	(5,746)	(19,585)
Purchase of premises and equipment	(101)	(1,227)
Purchase of land for potential future expansion	(542)	-
Proceeds from sale of premises and equipment	590	-
Proceeds from sale of foreclosed assets held for sale	372	665
Net cash used in investing activities	(52,880)	(49,222)

CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	38,834	49,682
Proceeds from long-term borrowings	3,013	3,163
Repayments of long-term borrowings	(7,000)	(3,324)
Net increase in short-term borrowed funds	835	2,500
Purchase of treasury and restricted stock	(796)	(381)
Dividends paid	(2,073)	(2,194)
Net cash provided by financing activities	32,813	49,446
Net (decrease) increase in cash and cash equivalents	(9,184)	8,617
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	43,995	31,449
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 34,811	$ 40,066
Supplemental Disclosures of Cash Flow Information:		
Interest paid	$ 7,669	$ 8,921
Income taxes paid	$ 2,015	$ 2,455
Loans transferred to foreclosed property	$ 670	$ 1,205

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 National 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, 2011 and 2010 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, 2011 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, 2010.

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. The Company has no dilutive securities.

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Net income applicable to common stock	$3,378,000	$2,897,000	$9,355,000	$8,570,000
Weighted average common shares outstanding	2,917,158	2,920,307	2,916,739	2,924,746
Earnings per share	$1.16	$0.99	$3.21	$2.93

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, 2011 and December 31, 2010 were as follows (in thousands):

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September 30, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. Agency securities	$ 156,583	$ 2,176	$ (55)	$ 158,704
Obligations of state and political subdivisions	93,114	3,510	(20)	96,604
Corporate obligations	8,301	228	-	8,529
Mortgage-backed securities in government sponsored entities	35,758	2,482	-	38,240
Equity securities in financial institutions	969	243	(50)	1,162
Total available-for-sale securities	$ 294,725	$ 8,639	$ (125)	$ 303,239

December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. Agency securities	$ 117,390	$ 1,535	$ (441)	$ 118,484
Obligations of state and political subdivisions	78,164	603	(1,845)	76,922
Corporate obligations	8,415	268	(2)	8,681
Mortgage-backed securities in government sponsored entities	43,183	2,832	-	46,015
Equity securities in financial institutions	914	303	(16)	1,201
Total available-for-sale securities	$ 248,066	$ 5,541	$ (2,304)	$ 251,303

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at September 30, 2011 and December 31, 2010 (in thousands). As of September 30, 2011 and December 31, 2010, the Company owned 19 and 85 securities whose fair value was less than their cost basis, respectively.

September 30, 2011	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Agency securities	$ 35,524	$ (55)	$ -	$ -	$ 35,524	$ (55)
Obligations of state and political subdivisions	1,052	(14)	769	(6)	1,821	(20)
Equity securities in financial institutions	78	(50)	-	-	78	(50)
Total securities	$ 36,654	$ (119)	$ 769	$ (6)	$ 37,423	$ (125)

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December 31, 2010	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	$ 38,502	$ (441)	$ -	$ -	$ 38,502	$ (441)
Obligations of states and political subdivisions	45,335	(1,784)	526	(61)	45,861	(1,845)
Corporate obligations	1,157	(2)	-	-	1,157	(2)
Equity securities in financial institutions	139	(16)	-	-	139	(16)
Total securities	$ 85,133	$ (2,243)	$ 526	$ (61)	$ 85,659	$ (2,304)

As of September 30, 2011, the Company's investment securities portfolio contained unrealized losses on obligations of U.S Agency securities, states and political subdivisions, and certain financial institutions equity securities. 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, 2011 and 2010 were $9,790,000 and $8,871,000, respectively. For the three months ended September 30, 2011, there were sales of $1,969,000 of available-for-sale securities. There were no sales during the three month period ended September 30, 2010. The gross gains and losses were as follows (in thousands):

	Three Months Ended September 30,		Nine months Ended September 30,	
	2011	2010	2011	2010
Gross gains	$ 161	$ -	$ 424	$ 99
Gross losses	(44)	-	(73)	-
Net gains	$ 117	$ -	$ 351	$ 99

Investment securities with an approximate carrying value of $175,946,000 and $162,742,000 at September 30, 2011 and December 31, 2010, 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, 2011, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Fair Value
Available-for-sale debt securities:		
Due in one year or less	$ 9,243	$ 9,325
Due after one year through five years	100,897	102,579
Due after five years through ten years	33,644	34,650
Due after ten years	149,972	155,523
Total	$ 293,756	$ 302,077

Note 5 – Loans

The Company grants commercial, industrial, agricultural, residential, and consumer loans primarily to customers throughout North Central Pennsylvania and Southern New York. Although the Company had a diversified loan portfolio at September 30, 2011 and December 31, 2010, 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 as of September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011	Total Loans	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate loans:			
Residential	$ 180,344	$ 142	$ 180,202
Commercial and agricultural	180,808	8,333	172,475
Construction	7,652	-	7,652
Consumer	11,080	-	11,080
Commercial and other loans	44,584	505	44,079
State and political subdivision loans	54,144	-	54,144
Total loans	$ 478,612	$ 8,980	$ 469,632
Less allowance for loan losses	6,323		
Net loans	$ 472,289		

December 31, 2010	Total Loans	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate loans:			
Residential	$ 185,012	$ 172	$ 184,840
Commercial and agricultural	171,577	9,976	161,601
Construction	9,766	-	9,766

Consumer		11,285	-	11,285
Commercial and other loans		47,156	1,374	45,782
State and political subdivision loans		48,721	-	48,721
Total	$	473,517 $	11,522 $	461,995
Less allowance for loan losses	5,915			
Net loans	$	467,602		

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

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

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, 2011	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Mortgages	$ 132	$ 124	$ -	$ 124	$ -	$ 128	$ -
Home Equity	18	-	18	18	3	30	-
Commercial	9,376	121	8,212	8,333	393	8,659	48
Agricultural	-	-	-	-	-	494	37
Construction	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-
Commercial and other loans	561	33	472	505	96	495	-
Other agricultural loans	-	-	-	-	-	213	20
State and political subdivision loans	-	-	-	-	-	-	-
Total	$ 10,087	$ 278	$ 8,702	$ 8,980	$ 492	$ 10,019	$ 105

December 31, 2010	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Mortgages	$ 132	$ -	$ 131	$ 131	$ 21	$ 55	$ -
Home Equity	72	41	-	41	-	56	-
Commercial	8,540	1,682	6,053	7,735	167	5,445	67
Agricultural	2,421	2,241	-	2,241	-	2,373	64
Construction	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-
Commercial and other loans	455	404	-	404	-	469	1
Other agricultural loans	1,040	970	-	970	-	958	11
State and political subdivision loans	-	-	-	-	-	-	-
Total	$ 12,660	$ 5,338	$ 6,184	$ 11,522	$ 188	$ 9,356	$ 143

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Credit Quality Information

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

- Pass (Grades 1-5) – These loans are to customers with credit quality ranging from an acceptable to very high quality and are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.

- Special Mention (Grade 6) – This loan grade is in accordance with regulatory guidance and includes loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

- Substandard (Grade 7) – This loan grade is in accordance with regulatory guidance and includes loans that have a well-defined weakness based on objective evidence and be characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

- Doubtful (Grade 8) – This loan grade is in accordance with regulatory guidance and includes loans that have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

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

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay loan as agreed, the Bank’s loan rating process includes several layers of internal and external oversight. The Company’s loan officers are responsible for the timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under the supervision of management. All commercial and agricultural loans are reviewed annually to ensure the appropriateness of the loan grade. In addition, the Bank engages an external consultant on at least an annual basis. The external consultant is engaged to 1) review a minimum of 60% of the dollar volume of the commercial loan portfolio on an annual basis, 2) review new loans originated in the last year, 3) review all relationships in aggregate over $500,000, 4) review all aggregate loan relationships over $100,000 which are over 90 days past due, 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, 2011 and December 31, 2010 (in thousands):

September 30, 2011	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	$ 135,356	$ 10,802	$ 15,803	$ -	$ -	$ 161,961
Agricultural	14,096	2,390	2,361	-	-	18,847
Construction	7,652	-	-	-	-	7,652
Commercial and other loans	34,489	3,044	786	17	-	38,336
	4,239	849	1,160	-	-	6,248

Other agricultural loans						
State and political subdivision loans	52,959	-	1,185	-	-	54,144
Total	$ 248,791	$ 17,085	$ 21,295	$ 17	$ -	$ 287,188

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December 31, 2010		Pass		Special Mention		Substandard		Doubtful		Loss		Ending Balance
Real estate loans:												
Commercial	$	120,344	$	15,570	$	16,585	$	-	$	-	$	152,499
Agricultural		12,007		1,063		6,008		-		-		19,078
Construction		9,766		-		-		-		-		9,766
Commercial and other loans		36,784		2,545		848		24		-		40,201
Other agricultural loans		4,024		469		2,462		-		-		6,955
State and political subdivision loans		47,482		-		1,239		-		-		48,721
Total	$	230,407	$	19,647	$	27,142	$	24	$	-	$	277,220

For residential real estate mortgages, home equities and consumer loans, credit quality is monitored based on whether the loan is performing or non-performing, which is typically based on the aging status of the loan and payment activity, unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. Non-performing loans include those loans that are considered nonaccrual, described in more detail below and all loans past due 90 or more days. The following table presents the recorded investment in those loan classes based on payment activity as of September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011		Performing		Non-performing		Total
Real estate loans:						
Mortgages	$	96,926	$	559	$	97,485
Home Equity		82,699		160		82,859
Consumer		11,080		-		11,080
Total	$	190,705	$	719	$	191,424

December 31, 2010		Performing		Non-performing		Total
Real estate loans:						
Mortgages	$	96,830	$	413	$	97,243
Home Equity		87,460		309		87,769
Consumer		11,278		7		11,285
Total	$	195,568	$	729	$	196,297

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, 2011 and December 31, 2010 (in thousands):

September 30, 2011	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	$ 195	$ 90	$ 482	$ 767	$ 96,718	$ 97,485	$ 110
Home Equity	329	27	161	517	82,342	82,859	14
Commercial	1,975	-	2,783	4,758	157,203	161,961	129
Agricultural	-	-	-	-	18,847	18,847	-
Construction	-	-	-	-	7,652	7,652	-
Consumer	10	10	-	20	11,060	11,080	-
Commercial and other loans	63	315	205	583	37,753	38,336	-
Other agricultural loans	-	-	-	-	6,248	6,248	-
State and political subdivision loans	-	-	-	-	54,144	54,144	-
Total	$ 2,572	$ 442	$ 3,631	$ 6,645	$ 471,967	$ 478,612	$ 253
Loans considered non-accrual	$ 76	$ 299	$ 3,378	$ 3,753	$ 5,681	$ 9,434	
Loans still accruing	2,496	143	253	2,892	466,286	469,178	
Total	$ 2,572	$ 442	$ 3,631	$ 6,645	$ 471,967	$ 478,612	

December 31, 2010	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	$ 518	$ 50	$ 412	$ 980	$ 96,263	$ 97,243	$ 104
Home Equity	762	139	262	1,163	86,606	87,769	116
Commercial	188	1,647	1,827	3,662	148,837	152,499	426
Agricultural	-	-	-	-	19,078	19,078	-
Construction	-	-	-	-	9,766	9,766	-
Consumer	83	3	7	93	11,192	11,285	6
Commercial and other loans	111	6	398	515	39,686	40,201	40
Other agricultural loans	5	-	-	5	6,950	6,955	
State and political subdivision loans	-	-	-	-	48,721	48,721	-
Total	$ 1,667	$ 1,845	$ 2,906	$ 6,418	$ 467,099	$ 473,517	$ 692
Loans considered non-accrual	$ -	$ 39	$ 2,214	$ 2,253	$ 9,600	$ 11,853	
Loans still accruing	1,667	1,806	692	4,165	457,499	461,664	
Total	$ 1,667	$ 1,845	$ 2,906	$ 6,418	$ 467,099	$ 473,517	

Nonaccrual Loans

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

The following table reflects the financing receivables on nonaccrual status as of September 30, 2011 and December 31, 2010, respectively. The balances are presented by class of financing receivable (in thousands):

	September 30, 2011	December 31, 2010
Real estate loans:		
Mortgages	$ 449	$ 309
Home Equity	146	193
Commercial	8,333	7,735
Agricultural	-	2,241
Construction	-	-
Consumer	-	1
Commercial and other	506	404
Other agricultural	-	970
State and political subdivision	-	-
	$ 9,434	$ 11,853

Troubled Debt Restructurings

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

Loan modifications that are considered TDR’s completed during the three months and nine months ended September 30, 2011 were as follows:

For the Three Months Ended September 30, 2011

	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
(Dollars in thousands)						
Real estate loans:						
Commercial	-	1	$ -	$ 47	$ -	$ 47

For the Nine Months Ended September 30, 2011

	Number of contracts		Pre-modification Outstanding Recorded Investment		Post-Modification Outstanding Recorded Investment	
	Interest Modification	Term Modification	Interest Modification	Term Modification	Interest Modification	Term Modification
(Dollars in thousands)						
Real estate loans:						
Commercial	5	1	$ 5,912	$ 47	$ 5,912	$ 47

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. Loan modifications considered TDR's made during the twelve months ended September 30, 2011, that defaulted during the nine month period ended September 30, 2011 were as follows:

(Dollars in thousands)	Number of contracts	Recorded investment
Real estate loans:		
Commercial	2	$ 109
Commercial and other loans	1	2
Total recidivism	3	$ 111

Allowance for Loan Losses

The following table rolls forward the balance of the allowance for loan and lease losses (ALLL) for the periods ended September 30, 2011 and 2010(in thousands):

	Three months Ended September 30,		Nine months Ended September 30,	
	2011	2010	2011	2010
	$ 6,163	$ 5,302	$ 5,915	$ 4,888

Balance, at beginning of period				
Provision charged to income	150	300	525	840
Recoveries on loans previously charged against the allowance	39	20	75	144
	6,352	5,622	6,515	5,872
Loans charged against the allowance	(29)	(34)	(192)	(284)
Balance, at end of year	$ 6,323	$ 5,588	$ 6,323	$ 5,588

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 / CPI

Changes in values of underlying collateral for collateral-dependent loans

- Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses; and
- Existence and effect of any credit concentrations, and changes in the level of such concentrations.

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

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

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

- The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were decreased for all loans portfolio types due to the decreases in nonaccrual loans from December 31, 2010 to September 30, 2011.
- The qualitative factors for changes in the trends of charge-offs and recoveries were decreased for consumer loans, commercial and agricultural loans due to reduced losses over the most recent three year period.
- The qualitative factors for changes in portfolio volumes during 2011 were reduced for agricultural loans due to the decreased size of the portfolio in relation to the total portfolio.
- Separate factors for special mention and substandard loans were developed for each qualitative factor reviewed.

Based on these qualitative factor changes for the nine month period ended September 30, 2011, and the changes in size of the loan portfolios since December 31, 2010, we recorded a negative provision for residential real estate, construction and other commercial loans, while increasing the provision associated with commercial and agricultural real estate loans.

During the third quarter, the only qualitative factor that experienced a significant change was that related to collateral values, which increased for residential and commercial real estate loans due to flooding our marketplace experienced late in the third quarter.

Based on the one qualitative factor change for the three month period ended September 30, 2011, and the changes the loan portfolios since June 30, 2011, we recorded an increased provision for residential and commercial real estate projects and a negative provision for other commercial loans.

The following tables roll forward the balance of the ALLL by portfolio segment for the three and nine month periods ended September 30, 2011 and segregates the ending balance into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of September 30, 2011 (in thousands):

For the Three Months Ended September 30, 2011

	Balance at June 30, 2011	Charge-offs	Recoveries	Provision	Balance at September 30, 2011	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate loans:							
Residential	$ 678	$ -	$ -	$ 147	$ 825	$ 3	$ 822
Commercial and agricultural	3,912	-	-	250	4,162	393	3,769
Construction	13	-	-	1	14	-	14
Consumer	109	(23)	16	12	114	-	114
Commercial and other loans	712	(6)	23	(40)	689	96	593
State and political subdivision loans	119	-	-	- 1	120	-	120
Unallocated	620	-	-	(221)	399	-	399
Total	$ 6,163	$ (29)	$ 39	$ 150	$ 6,323	$ 492	$ 5,831

For the Nine Months Ended September 30, 2011

	Balance at December 31, 2010	Charge-offs	Recoveries	Provision	Balance at September 30, 2011	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate loans:							
Residential	$ 969	$ (101)	$ -	$ (43)	$ 825	$ 3	$ 822
Commercial and agricultural	3,380	(29)	-	811	4,162	393	3,769
Construction	22	-	-	(8)	14	-	14
Consumer	108	(56)	45	17	114	-	114
Commercial and other loans	983	(6)	30	(318)	689	96	593
State and political subdivision loans	137	-	-	(17)	120	-	120
Unallocated	316	-	-	83	399	-	399
Total	$ 5,915	$ (192)	$ 75	$ 525	$ 6,323	$ 492	$ 5,831

Note 6 – Federal Home Loan Bank Stock

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB) 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, 2011 and December 31, 2010, the Bank held $3,186,300 and $3,498,000, respectively of FHLB stock. The stock is bought from and sold to the FHLB based upon its $100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated for impairment by management. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the Federal Home Loan Bank as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB.

The FHLB has incurred a significant cumulative loss in regards to comprehensive income and net income in the three years ended December 31, 2010 and has suspended the payment of dividends; however, the results for the nine months ended September 30, 2011 and the full year results for 2010 were significantly improved from those of 2008 and 2009. The cumulative losses are primarily attributable to impairment of investment securities associated with the distressed economic conditions during 2008 and 2009. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB's regulatory capital ratios have improved in the most recent quarters, liquidity appears adequate, and 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 in the past three quarters.

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 2010 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, 2008 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, 2008 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, 2011 and 2010, respectively (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Service cost	$ 71	$ 45	$ 256	$ 259
Interest cost	88	59	314	340
Expected return on plan assets	(129)	(77)	(465)	(446)
Net amortization and deferral	10	6	36	37
Net periodic benefit cost	$ 40	$ 33	$ 141	$ 191

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The Company contributed $505,000 to the Pension Plan in 2011.

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 $174,000 and $171,000 for the nine months ended September 30, 2011 and 2010, respectively.

Directors' Deferred Compensation Plan

The Company's directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. Amounts included in interest expense on the deferred amounts totaled $17,000 and $22,000 for the nine months ended September 30, 2011 and 2010, respectively.

Restricted Stock Plan

The Company maintains a Restricted Stock Plan (the "Plan") whereby employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company's common stock and are subject to certain vesting requirements including continuous employment or service with the Company. 100,000 shares of the Company's common stock have been authorized under the Plan. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

For the nine months ended September 30, 2011 and 2010, 3,968 and 5,090 shares of restricted stock were awarded and 5,502 and 4,948 shares vested, respectively. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. Compensation expense related to restricted stock was $109,000 and $94,000 for the nine months ended September 30, 2011 and 2010, 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, 2011 and December 31, 2010, an obligation of $793,000 and $747,000, respectively, was included in other liabilities for this plan in the consolidated balance sheet. Expenses related to this plan totaled $46,000 and $248,000 for the nine months ended September 30, 2011 and 2010, respectively.

Note 8 – Fair Value Measurements

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

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

Level II:	Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.
Level III:	Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management’s best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

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

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

Financial Instruments Recorded at Fair Value on a Recurring Basis

The fair values of securities available for sale are determined by quoted prices in active markets, when available, and classified as Level 1. 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 2. The fair values consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things. In cases where significant credit valuation adjustments are incorporated into the estimation of fair value, reported amounts are classified as Level 3 inputs.

Currently, we use an interest rate swap, which is a derivative, to manage our interest rate risk related to the trust preferred security. The valuation of this instrument is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative and classified as Level 2. 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, 2011 and December 31, 2010 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, 2011			
	Level 1	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Assets				
Securities available for sale:				
U.S. Agency securities	$ -	$ 158,704	$ -	$ 158,704
Obligations of state and political subdivisions	-	96,604	-	96,604
Corporate obligations	-	8,529	-	8,529
Mortgage-backed securities in government sponsored entities	-	38,240	-	38,240
Equity securities in financial institutions	1,162	-	-	1,162
Liabilities				
Trust Preferred Interest Rate Swap	-	(414)	-	(414)

	December 31, 2010			
	Level 1	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Assets				
Securities available for sale:				
U.S. Agency securities	$ -	$ 118,484	$ -	$ 118,484
Obligations of state and political subdivisions	-	76,922	-	76,922
Corporate obligations	-	8,681	-	8,681
Mortgage-backed securities in government sponsored entities	-	46,015	-	46,015
Equity securities in financial institutions	1,201	-	-	1,201
Liabilities				

Trust Preferred Interest Rate Swap	-	(409)	-	(409)

Financial Instruments Recorded at Fair Value on a Nonrecurring Basis

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

Impaired Loans- Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310. The fair value of impaired loans is estimated 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.

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

The Corporation has no non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Certain non-financial assets measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. Non-financial assets measured at fair value on a non-recurring basis during 2011 and 2010 include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for possible loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense. The fair value of a foreclosed asset is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria.

Assets measured at fair value on a nonrecurring basis as of September 30, 2011 and December 31, 2010 are included in the table below (in thousands):

	September 30, 2011			
	Level 1	Level II	Level III	Total
Impaired Loans	$ -	$ -	$ 8,488	$ 8,488
Other real estate owned	-	-	948	948

	December 31, 2010			
	Level 1	Level II	Level III	Total
Impaired Loans	$ -	$ 2,238	$ 9,096	$ 11,334
Other real estate owned	-	693	-	693

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

	September 30 2011		December 31 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and due from banks	$ 34,811	$ 34,811	$ 43,995	$ 43,995
Available-for-sale securities	303,239	303,239	251,303	251,303
Net loans	472,289	517,077	467,602	494,098
Bank owned life insurance	13,542	13,542	13,171	13,171
Regulatory stock	3,461	3,461	3,773	3,773
Accrued interest receivable	3,980	3,980	3,455	3,455
Financial liabilities:				
Deposits	$ 719,545	$ 727,009	$ 680,711	$ 683,315
Borrowed funds	52,845	50,193	55,996	52,820
Trust preferred interest rate swap	414	414	409	409
Accrued interest payable	1,539	1,539	1,779	1,779

Fair value is determined, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the estimates.

Fair values have been determined by the Company using historical data, as generally provided in the Company's regulatory reports, and an estimation methodology suitable for each category of financial instruments. The Company's fair value estimates, methods and assumptions are set forth below for the Company's other financial instruments.

Cash and Cash Equivalents:

The carrying amounts for cash and due from banks approximate fair value because they have original maturities of 90 days or less and do not present unanticipated credit concerns.

Accrued Interest Receivable and Payable:

The carrying amounts for accrued interest receivable and payable approximate fair value because they are generally received or paid in 90 days or less and do not present unanticipated credit concerns.

Available-For-Sale Securities:

The fair values of available-for-sale securities are based on quoted market prices as of the balance sheet date. For certain instruments, fair value is estimated by obtaining quotes from independent dealers.

Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans has been estimated by discounting expected future cash flows. The discount rate used in these calculations is derived from the Treasury yield curve adjusted for credit quality, operating expense and prepayment option price, and is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified as required by an estimate of the effect of current economic and lending conditions.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discount rates are judgmentally determined using available market information and specific borrower information.

Bank Owned Life Insurance:

The carrying value of bank owned life insurance approximates fair value based on applicable redemption provisions.

Regulatory Stock:

The carrying value of regulatory stock approximates fair value based on applicable redemption provisions.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings and NOW accounts, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

The deposits' fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

Borrowed Funds:

Rates available to the Company for borrowed funds with similar terms and remaining maturities are used to estimate the fair value of borrowed funds.

Trust Preferred Interest Rate Swap:

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

Note 9 – Recent Accounting Pronouncements

In December 2010, the FASB issued ASU 2010-29, Disclosure of Supplementary Pro Forma Information for Business Combinations. The amendments in this update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also expand the supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amendments in this Update are effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. This ASU is not expected to have a significant impact on the Company’s financial statements.

In April 2011, the FASB issued ASU 2011-02, Receivables (Topic 310): A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The amendments in this Update provide additional guidance or clarification to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The amendments in this Update are effective for the first interim or annual reporting period beginning on or after September 15, 2011, and should be applied retrospectively to the beginning annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company has provided the necessary disclosures in Note 5.

In April 2011, the FASB issued ASU 2011-03, Reconsideration of Effective Control for Repurchase Agreements. The main objective in developing this Update is to improve the accounting for repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments in this Update remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this Update apply to all entities, both public and nonpublic. The amendments affect all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The guidance in this Update is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is currently evaluating the impact the adoption of the standard will have on the Company’s financial position or results of operations.

In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

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

In September 2011, the FASB issued ASU 2011-08, Intangibles – Goodwill and Other Topics (Topic 350), Testing Goodwill for Impairment. The objective of this update is to simplify how entities, both public and nonpublic, test goodwill for impairment. The amendments in the Update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this Update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this Update apply to all entities, both public and nonpublic, that have goodwill reported in their financial statements and are effective for interim and annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. This ASU is not expected to have a significant impact on the Company's financial statements.

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 National Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use words such as "believes," "expects," "anticipates," or similar expressions, we are making forward-looking statements. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements. The Company would like to caution readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement:

- Interest rates could change more rapidly or more significantly than we expect.
- The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
- The stock and bond markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.
- It could take us longer than we anticipate implementing strategic initiatives designed to increase revenues or manage expenses, or we may not be able to implement those initiatives at all.
- Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.
- We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices, regulations or requirements, including the costs of compliance with such changes.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition. We could also experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.
- Exploration and drilling of the natural gas reserves in the Marcellus Shale in our market area may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection, which could negatively impact our customers and, as a result, negatively impact our loan and deposit volume and loan quality.

Additional factors that may affect our results are discussed under "Part II – Item 1A – Risk Factors" in this report and in the Company's 2010 Annual Report on Form 10-K under "Item 1.A/ Risk Factors." Except as required by applicable law and regulation, we assume no obligation to update or revise any forward-looking statements after the date on which they are made.

Introduction

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in the accompanying consolidated financial statements for the Company. Our Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three and nine months ended

September 30, 2011 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 18 banking facilities. In Pennsylvania, we have branch offices located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Wellsboro Weis Market store and the Mansfield Wal-Mart Super Center. We also have a loan production office in Lock Haven, Pennsylvania. In New York, we have a branch office in Wellsville, Allegany County.

Risk Management

Risk identification and management are essential elements for the successful management of the Company. In the normal course of business, the Company is subject to various types of risk, including interest rate, credit, liquidity, reputational and regulatory risk.

Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the direction and frequency of changes in interest rates. Interest rate risk results from various re-pricing frequencies and the maturity structure of the financial instruments owned by the Company. The Company uses its asset/liability and funds management policy to control and manage interest rate risk.

Credit risk represents the possibility that a customer may not perform in accordance with contractual terms. Credit risk results from loans with customers and the purchasing of securities. The Company’s primary credit risk is in the loan portfolio. The Company manages credit risk by adhering to an established credit policy and through a disciplined evaluation of the adequacy of the allowance for loan losses. Also, the investment policy limits the amount of credit risk that may be taken in the investment portfolio.

Liquidity risk represents the inability to generate or otherwise obtain funds at reasonable rates to satisfy commitments to borrowers and obligations to depositors. The Company has established guidelines within its asset/liability and funds management policy to manage liquidity risk. These guidelines include, among other things, contingent funding alternatives.

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

Regulatory risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company and its subsidiary. We cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.

Competition

The banking industry in the Bank’s service area continues to be extremely competitive, both among commercial banks and with financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions and internet banks. 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. 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, 2011 and December 31, 2010, the Trust Department had $92.6 and $95.1 million of assets under management, respectively. The $2.5 million decrease is primarily attributable to net additions of $5.0 million with the remaining change the result of fluctuations in the stock market.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance. The assets associated with these products are not included in the consolidated financial statements since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from $70.1 million at December 31, 2010 to $76.4 million at September 30, 2011. Fee income from the sale of these products is reflected in the Company's financial statements as a component of non-interest income in the Consolidated Statement of Income.

In addition to the Trust and Investment services offered we have created an oil and gas management team, which serves as a network of experts to assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. We have partnered with a professional firm to provide mineral management expertise and services to customers in our market who have been impacted by the Marcellus Shale exploration and drilling activities. Through this relationship, we are able to assist customers negotiate 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 $9,355,000 for the first nine months of 2011 compared to earnings of $8,570,000 for last year's comparable period, an increase of $785,000 or 9.2%. Earnings per share for the first nine months of 2011 were $3.21, compared to $2.93 last year, representing a 9.6% increase. Annualized return on assets and return on equity for the nine months of 2011 were 1.49% and 17.65%, respectively, compared with 1.51% and 18.31% for last year's comparable period.

Net income for the three months ended September 30, 2011 was $3,378,000 compared to earnings of $2,897,000 in the comparable 2010 period, an increase of $481,000. Earnings per share for the three months ended September 30, 2011 and 2010 were $1.16 and $0.99 per share, respectively. Annualized return on assets and return on equity for the quarter ended September 30, 2011 was 1.57% and 18.48%, respectively, compared with 1.49% and 17.98% for the same 2010 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 2011 was $21,219,000, an increase of $650,000, or 3.2%, compared to the same period in 2010. For the first nine months of 2011, the provision for loan losses totaled $525,000, a decrease of $315,000 over the comparable period in 2010. Consequently, net interest income after the provision for loan losses was $20,694,000 compared to $19,729,000 during the first nine months of 2010.

For the three months ended September 30, 2011, net interest income was $7,207,000 compared to $7,013,000, an increase of $194,000, or 2.8% over the comparable period in 2010. The provision for loan losses this quarter was $150,000 compared to $300,000 for last year's third quarter. Consequently, net interest income after the provision for loan losses was $7,057,000 for the quarter ended September 30, 2011 compared to $6,713,000 in 2010.

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, 2011 and 2010 on a tax equivalent basis (dollars in thousands):

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

	September 30, 2011			September 30, 2010		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%
ASSETS						
Short-term investments:						
Interest-bearing deposits at banks	32,063	64	0.27	25,555	55	0.29
Total short-term investments	32,063	64	0.27	25,555	55	0.29
Investment securities:						
Taxable	195,318	3,482	2.38	145,917	3,804	3.48
Tax-exempt (3)	88,657	4,073	6.13	67,474	3,243	6.41
Total investment securities	283,975	7,555	3.55	213,391	7,047	4.40
Loans:						
Residential mortgage loans	188,108	9,648	6.86	202,500	10,746	7.09
Commercial & agricultural loans	222,859	10,684	6.41	206,158	10,345	6.71
Loans to state & political subdivisions	51,198	2,016	5.26	46,810	2,069	5.91
Other loans	10,869	691	8.50	11,526	751	8.71
Loans, net of discount (2)(3)(4)	473,034	23,039	6.51	466,994	23,911	6.85
Total interest-earning assets	789,072	30,658	5.19	705,940	31,013	5.87
Cash and due from banks	9,937			9,450		
Bank premises and equipment	12,232			12,577		
Other assets	28,605			28,917		
Total non-interest earning assets	50,774			50,944		
Total assets	839,846			756,884		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
NOW accounts	188,088	708	0.50	149,503	794	0.71
Savings accounts	69,520	155	0.30	53,519	120	0.30
Money market accounts	55,605	219	0.53	45,151	189	0.56
Certificates of deposit	314,221	5,021	2.14	322,036	6,271	2.60
Total interest-bearing deposits	627,434	6,103	1.30	570,209	7,374	1.73
Other borrowed funds	56,141	1,325	3.16	53,281	1,324	3.32
	683,575	7,428	1.45	623,490	8,698	1.87

Total interest-bearing liabilities						
Demand deposits	78,195			63,366		
Other liabilities	7,394			7,641		
Total non-interest-bearing liabilities	85,589			71,007		
Stockholders' equity	70,682			62,387		
Total liabilities & stockholders' equity	839,846			756,884		
Net interest income		23,230			22,315	
Net interest spread (5)			3.74%			4.00%
Net interest income as a percentage						
of average interest-earning assets			3.94%			4.23%
Ratio of interest-earning assets						
to interest-bearing liabilities			1.15			1.13

(1) Averages are based on daily averages.
(2) Includes loan origination and commitment fees.
(3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%.
(4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.
(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Analysis of Average Balances and Interest Rates (1)

Three Months Ended					
September 30, 2011			September 30, 2010		
Average		Average	Average		Average