

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

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

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

For the quarterly period ended September 30, 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  
(State or other jurisdiction of incorporation or organization)  
No.)

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

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

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Citizens Financial Services, Inc.  
Form 10-Q

INDEX

|          |  | PAGE  |
|----------|--|-------|
| Part I   | FINANCIAL INFORMATION  |       |
| Item 1.  | Financial Statements (unaudited):  |       |
|          | Consolidated Balance Sheet as of September 30, 2013 and December 31, 2012                                      | 1     |
|          | Consolidated Statement of Income for the Three and Nine Months Ended September 30, 2013 and 2012               | 2     |
|          | Consolidated Statement of Comprehensive Income for the Three and Nine Months ended September 30, 2013 and 2012 | 3     |
|          | Consolidated Statement of Cash Flows for the Nine Months ended September 30, 2013 and 2012                     | 4     |
|          | Notes to Consolidated Financial Statements   | 5-27  |
| Item 2.  | Management's Discussion and Analysis of Financial Condition and Results of Operations                          | 28-49 |
| Item 3.  | Quantitative and Qualitative Disclosures About Market Risk   | 49-50 |
| Item 4.  | Controls and Procedures  | 50    |
| Part II  | OTHER INFORMATION  |       |
| Item 1.  | Legal Proceedings  | 50    |
| Item 1A. | Risk Factors   | 50-51 |
| Item 2.  | Unregistered Sales of Equity Securities and Use of Proceeds  | 51    |
| Item 3.  | Defaults Upon Senior Securities  | 51    |
| Item 4.  | Mine Safety Disclosures  | 51    |
| Item 5.  | Other Information  | 51    |
| Item 6.  | Exhibits   | 51-52 |
|          | Signatures   | 53    |

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

| (in thousands except share data)   | September 30<br>2013 | December<br>31<br>2012 |
|--|----------------------|------------------------|
| <b>ASSETS:</b>   |                      |                        |
| 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:<br>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                  |
| <b>TOTAL ASSETS</b>  | <b>\$ 899,396</b>    | <b>\$ 882,427</b>      |
| <b>LIABILITIES:</b>  |                      |                        |
| 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                  |
| <b>TOTAL LIABILITIES</b>   | <b>809,016</b>       | <b>792,952</b>         |
| <b>STOCKHOLDERS' EQUITY:</b>   |                      |                        |
| 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)<br>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)           |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>       | <b>90,380</b>     | <b>89,475</b>     |
| <b>TOTAL LIABILITIES AND</b>            |                   |                   |
| <b>STOCKHOLDERS' EQUITY</b>             | <b>\$ 899,396</b> | <b>\$ 882,427</b> |

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

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

|  | Three Months Ended<br>September 30 |              | Nine Months Ended<br>September 30, |               |
|--|------------------------------------|--------------|------------------------------------|---------------|
| (in thousands, except per share<br>data)                               | 2013                               | 2012         | 2013                               | 2012          |
| <b>INTEREST INCOME:</b>  |                                    |              |                                    |               |
| Interest and fees on loans   | \$ 7,521                           | \$ 7,448     | \$ 21,799                          | \$ 22,352     |
| Interest-bearing deposits with<br>banks                                | 8                                  | 5            | 27                                 | 11            |
| <b>Investment securities:</b>  |                                    |              |                                    |               |
| Taxable  | 905                                | 1,085        | 2,804                              | 3,519         |
| Nontaxable   | 850                                | 919          | 2,563                              | 2,793         |
| Dividends  | 23                                 | 17           | 61                                 | 49            |
| <b>TOTAL INTEREST INCOME</b>   | <b>9,307</b>                       | <b>9,474</b> | <b>27,254</b>                      | <b>28,724</b> |
| <b>INTEREST EXPENSE:</b>   |                                    |              |                                    |               |
| Deposits   | 1,279                              | 1,486        | 3,894                              | 4,707         |
| Borrowed funds   | 283                                | 373          | 951                                | 1,179         |
| <b>TOTAL INTEREST EXPENSE</b>  | <b>1,562</b>                       | <b>1,859</b> | <b>4,845</b>                       | <b>5,886</b>  |
| <b>NET INTEREST INCOME</b>   | <b>7,745</b>                       | <b>7,615</b> | <b>22,409</b>                      | <b>22,838</b> |
| Provision for loan losses  | 90                                 | 105          | 315                                | 315           |
| <b>NET INTEREST INCOME<br/>AFTER<br/>PROVISION FOR LOAN<br/>LOSSES</b> |                                    |              |                                    |               |
|  | <b>7,655</b>                       | <b>7,510</b> | <b>22,094</b>                      | <b>22,523</b> |
| <b>NON-INTEREST INCOME:</b>  |                                    |              |                                    |               |
| 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<br>insurance                               | 127                                | 128          | 377                                | 378           |
| Other  | 124                                | 109          | 328                                | 342           |
| <b>TOTAL NON-INTEREST<br/>INCOME</b>                                   | <b>1,806</b>                       | <b>1,946</b> | <b>5,401</b>                       | <b>5,691</b>  |
| <b>NON-INTEREST EXPENSES:</b>  |                                    |              |                                    |               |
| 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         |
| <b>TOTAL NON-INTEREST<br/>EXPENSES</b>                                 | <b>4,920</b>                       | <b>4,959</b> | <b>14,574</b>                      | <b>14,352</b> |
|  | <b>4,541</b>                       | <b>4,497</b> | <b>12,921</b>                      | <b>13,862</b> |

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.

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

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



CITIZENS FINANCIAL SERVICES,  
INC.CONSOLIDATED STATEMENT OF  
CASH FLOWS

(UNAUDITED)

Nine Months Ended

September 30,

2013

2012

(in thousands)

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)         |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>            |                  |                  |
| 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)         |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b> | <b>26,333</b>    | <b>30,432</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>       | <b>\$ 13,756</b> | <b>\$ 10,710</b> |

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<br>September 30, |             | Nine months ended<br>September 30, |              |
|---|-------------------------------------|-------------|------------------------------------|--------------|
|   | 2013                                | 2012        | 2013                               | 2012         |
| Net income applicable to common stock                                   | \$3,512,000                         | \$3,464,000 | \$10,079,000                       | \$10,666,000 |
| <b>Basic earnings per share computation</b>                             |                                     |             |                                    |              |
| 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       |
| <b>Diluted earnings per share computation</b>                           |                                     |             |                                    |              |
| 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):

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2013                          |                   |                              |                               |               |
| 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.

6

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| September<br>30, 2013  | Less than Twelve<br>Months |                               | Twelve Months or<br>Greater |                               | Total         |                               |
|--|----------------------------|-------------------------------|-----------------------------|-------------------------------|---------------|-------------------------------|
|  | Fair<br>Value              | Gross<br>Unrealized<br>Losses | Fair<br>Value               | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses |
| U.S.<br>agency<br>securities \$  | 80,162 \$                  | (1,607) \$                    | - \$                        | - \$                          | 80,162 \$     | (1,607)                       |
| U.S.<br>treasury<br>securities   | 11,480                     | (370)                         | -                           | (11,480)                      |               | (370)                         |
| Obligations<br>of state<br>and<br>political<br>subdivisions                | 22,396                     | (978)                         | 1,642                       | (60)                          | 22,038        | (1,038)                       |
| Corporate<br>obligations   | 12,009                     | (476)                         | -                           | -                             | 12,009        | (476)                         |
| Mortgage-backed<br>securities<br>in<br>government<br>sponsored<br>entities | 14,672                     | (176)                         | 827                         | (14)                          | 15,499        | (190)                         |
| Total<br>securities \$   | 138,719 \$                 | (3,607) \$                    | 2,469 \$                    | (74) \$                       | 141,188 \$    | (3,681)                       |
| December<br>31, 2012   |                            |                               |                             |                               |               |                               |
| U.S.<br>agency<br>securities \$  | 6,016 \$                   | (41) \$                       | - \$                        | - \$                          | 6,016 \$      | (41)                          |
| Obligations<br>of states<br>and<br>political<br>subdivisions               | 7,981                      | (134)                         | -                           | -                             | 7,981         | (134)                         |
| Corporate<br>obligations   | 10,972                     | (42)                          | -                           | -                             | 10,972        | (42)                          |
| Mortgage-backed<br>securities<br>in<br>government<br>sponsored<br>entities | 8,651                      | (127)                         | -                           | -                             | 8,651         | (127)                         |
| Total<br>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 |        | Nine Months Ended |        |
|--------------|--------------------|--------|-------------------|--------|
|              | September 30,      |        | September 30,     |        |
|              | 2013               | 2012   | 2013              | 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 |

8

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



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| September 30,<br>2013                          | Unpaid<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|--------------------------------|--|---|---------------------------------|----------------------|
| Real estate<br>loans:                          |                                |  |   |                                 |                      |
| Mortgages                                      | \$ 375                         | \$ 141   | \$ 206                                      | \$ 347                          | \$ 24                |
| Home<br>Equity                                 | 135                            | -  | 135   | 135                             | 13                   |
| Commercial                                     | 10,052                         | 5,714  | 2,880                                       | 8,594                           | 560                  |
| Agricultural                                   | -                              | -  | -   | -                               | -                    |
| Construction                                   | -                              | -  | -   | -                               | -                    |
| Consumer                                       | 15                             | 15   | -   | 15                              | -                    |
| Other<br>commercial<br>loans                   | 1,851                          | 1,438  | 357   | 1,795                           | 1                    |
| Other<br>agricultural<br>loans                 | -                              | -  | -   | -                               | -                    |
| State and<br>political<br>subdivision<br>loans | -                              | -  | -   | -                               | -                    |
| Total  | \$ 12,428                      | \$ 7,308                                       | \$ 3,578                                    | \$ 10,886                       | \$ 598               |

| December 31,<br>2012                           | Unpaid<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|--------------------------------|--|---|---------------------------------|----------------------|
| Real estate<br>loans:                          |                                |  |   |                                 |                      |
| Mortgages                                      | \$ 309                         | \$ 150   | \$ 136                                      | \$ 286                          | \$ 8                 |
| Home<br>Equity                                 | 138                            | -  | 138   | 138                             | 14                   |
| Commercial                                     | 10,669                         | 6,476  | 2,617                                       | 9,093                           | 559                  |
| Agricultural                                   | -                              | -  | -   | -                               | -                    |
| Construction                                   | -                              | -  | -   | -                               | -                    |
| Consumer                                       | -                              | -  | -   | -                               | -                    |
| Other<br>commercial<br>loans                   | 950                            | 592  | 309   | 901                             | 1                    |
| Other<br>agricultural<br>loans                 | -                              | -  | -   | -                               | -                    |
| State and<br>political<br>subdivision<br>loans | -                              | -  | -   | -                               | -                    |
| Total  | \$ 12,066                      | \$ 7,218                                       | \$ 3,200                                    | \$ 10,418                       | \$ 582               |

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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<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis |
| Real estate<br>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<br>commercial<br>loans                   | 1,647                             | 17                               | -  | 382                               | -                                | -  |
| Other<br>agricultural<br>loans                 | -                                 | -                                | -  | -                                 | -                                | -  |
| State and<br>political<br>subdivision<br>loans | -                                 | -                                | -  | -                                 | -                                | -  |
| <b>Total</b>                                   | <b>\$ 10,508</b>                  | <b>\$ 362</b>                    | <b>\$ 326</b>                                  | <b>\$ 8,146</b>                   | <b>\$ 37</b>                     | <b>\$ 22</b>                                   |

### 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.



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The following tables represent credit exposures by internally assigned grades as of September 30, 2013 and December 31, 2012 (in thousands):

| September 30,<br>2013                 | Pass              | Special<br>Mention | Substandard      | Doubtful      | Loss        | Ending<br>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            |
| <b>Total</b>                          | <b>\$ 292,232</b> | <b>\$ 9,281</b>    | <b>\$ 27,251</b> | <b>\$ 219</b> | <b>\$ -</b> | <b>328,983</b>    |
| 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            |
| <b>Total</b>                          | <b>\$ 277,785</b> | <b>\$ 11,417</b>   | <b>\$ 24,547</b> | <b>\$ 75</b>  | <b>\$ -</b> | <b>313,824</b>    |

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<br>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):

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|   | 30-59<br>Days | 60-89<br>Days | 90 Days<br>Or Greater | Total Past<br>Due | Total Financing<br>Current | 90 Days and<br>Accruing |          |
|---|---------------|---------------|-----------------------|-------------------|----------------------------|-------------------------|----------|
| September<br>30,<br>2013                          | Past Due      | Past Due      | Or Greater            | Due               | Current                    | Receivables             | Accruing |
| Real<br>estate<br>loans:                          |               |               |                       |                   |                            |                         |          |
| Mortgages   | 935 \$        | 140 \$        | 600 \$                | 1,675 \$          | 113,334 \$                 | 115,009 \$              | 195      |
| Home<br>Equity                                    | 539           | 137           | 230                   | 906               | 67,455                     | 68,361                  | 94       |
| Commercial  | 1186          | 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<br>commercial<br>loans                      | 17            | 65            | 351                   | 433               | 44,447                     | 44,880                  | -        |
| Other<br>agricultural<br>loans                    | -             | -             | -                     | -                 | 9,280                      | 9,280                   | -        |
| State<br>and<br>political<br>subdivision<br>loans | -             | -             | -                     | -                 | 60,105                     | 60,105                  | -        |
| Total   | \$ 2,848 \$   | \$ 641 \$     | \$ 4,200 \$           | \$ 7,689 \$       | \$ 514,643 \$              | \$ 522,332 \$           | 588      |
| Loans<br>considered<br>non-accruing               | 127 \$        | 425 \$        | 3,612 \$              | 4,164 \$          | 4,533 \$                   | 8,697                   |          |
| Loans<br>still<br>accruing                        | 2,721         | 216           | 588                   | 3,525             | 510,110                    | 513,635                 |          |
| Total   | \$ 2,848 \$   | \$ 641 \$     | \$ 4,200 \$           | \$ 7,689 \$       | \$ 514,643 \$              | \$ 522,332              |          |

|                          |        |        |        |          |            |            |     |
|--------------------------|--------|--------|--------|----------|------------|------------|-----|
| December<br>31,<br>2012  |        |        |        |          |            |            |     |
| Real<br>estate<br>loans: |        |        |        |          |            |            |     |
| Mortgages                | 636 \$ | 294 \$ | 493 \$ | 1,423 \$ | 105,125 \$ | 106,548 \$ | 244 |
| Home<br>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,<br>2013 | December 31,<br>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 |      | Post-Modification Outstanding |      |
| Interest                                     | Term | Interest                     | Term | Interest                      | Term |
|  |      |                              |      |                               |      |

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|                        | 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        |

For the Three Months Ended September 30, 2012

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

For the Nine Months Ended September 30, 2012

|                      | Number of contracts |              | Pre-modification Outstanding |              | Post-Modification Outstanding |              |
|----------------------|---------------------|--------------|------------------------------|--------------|-------------------------------|--------------|
|                      | Interest            | Term         | Interest                     | Term         | Interest                      | Term         |
|                      | Modification        | Modification | Modification                 | Modification | Modification                  | 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              | -                          | \$ -                | -                   | \$ -                | -                         | \$ -                | 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 | Collectively evaluated for | Total |
|  |                            |                            |       |                            |                            |       |

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

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

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

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|  | \$                                 | 6,650        | \$        | (32)         | \$        | 11          | \$         | 105        | \$                                  | 6,734        |
|--|------------------------------------|--------------|-----------|--------------|-----------|-------------|------------|------------|-------------------------------------|--------------|
|  | Balance at<br>December 31,<br>2011 |              |           |              |           | Charge-offs | Recoveries | Provision  | Balance at<br>September<br>30, 2012 |              |
| <b>Real estate loans:</b>                  |                                    |              |           |              |           |             |            |            |                                     |              |
| Residential                                | \$                                 | 805          | \$        | (49)         | \$        | -           | \$         | 109        | \$                                  | 865          |
| Commercial and<br>agricultural             |                                    | 4,132        |           | (2)          |           | 7           |            | 94         |                                     | 4,231        |
| Construction                               |                                    | 15           |           | -            |           | -           |            | 11         |                                     | 26           |
| Consumer                                   |                                    | 111          |           | (36)         |           | 25          |            | 4          |                                     | 104          |
| Other commercial and<br>agricultural loans |                                    | 674          |           | (20)         |           | 7           |            | 5          |                                     | 666          |
| State and political<br>subdivision loans   |                                    | 235          |           | -            |           | -           |            | 39         |                                     | 274          |
| Unallocated                                |                                    | 515          |           | -            |           | -           |            | 53         |                                     | 568          |
| <b>Total</b>                               | <b>\$</b>                          | <b>6,487</b> | <b>\$</b> | <b>(107)</b> | <b>\$</b> | <b>39</b>   | <b>\$</b>  | <b>315</b> | <b>\$</b>                           | <b>6,734</b> |

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 reinstated 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<br>Ended<br>September 30, |       | Nine Months Ended<br>September 30, |        |
|--------------------------------------|--|-------|------------------------------------|--------|
|                                      | 2013                                   | 2012  | 2013                               | 2012   |
| Service cost                         | \$ 81                                  | \$ 82 | \$ 258                             | \$ 249 |
| Interest cost                        | 89                                     | 85    | 274                                | 259    |
| Expected<br>return on plan<br>assets | (165)                                  | (139) | (508)                              | (425)  |
| Net<br>amortization<br>and deferral  | 66                                     | 34    | 194                                | 102    |
| Net periodic<br>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                         | Weighted Average Market Price | Unvested | Weighted Average Market Price | Unvested                        | Weighted Average Market Price | Unvested | Weighted Average Market Price |
|                                  | Shares                           | Market Price                  | Shares   | Price                         | Shares                          | Market Price                  | Shares   | 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       |                    | Defined Benefit |          |  |
|  | (loss)                | Unrealized gain    | Pension Items   |          |  |
|  | on available for sale | (loss) on interest |                 |          |  |
|  | securities (a)        | rate swap (a)      | (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       |                    | Defined Benefit |          |  |
|  | (loss)                | Unrealized gain    | Pension Items   |          |  |
|  | on available for sale | (loss) on interest |                 |          |  |
|  | securities (a)        | rate swap (a)      | (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<br>September 30, 2013 |      | Nine Months<br>Ended | presented                              |
|---|--|------|----------------------|--|
| Unrealized gains and losses on<br>available for sale securities | \$                                       | 91   | \$                   | 385                                    |
|   |  | (30) |                      | (130)                                  |
|   | \$                                       | 61   | \$                   | 255                                    |
|   |  |      |                      | Investment<br>securities gains,<br>net |
|   |  |      |                      | Provision for<br>income taxes          |
|   |  |      |                      | Net of tax                             |
| Defined benefit pension items                                   |  |      |                      |  |
|   | \$                                       | (66) | \$                   | (194)                                  |
|   |  | 22   |                      | 66                                     |
|   | \$                                       | (44) | \$                   | (128)                                  |
|   |  |      |                      | Salaries and<br>employee<br>benefits   |
|   |  |      |                      | Provision for<br>income taxes          |
|   |  |      |                      | 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,<br>2013   | Level I | Level II | Level III | Total     |
|-------------------------|---------|----------|-----------|-----------|
| Impaired Loans          | \$ -    | \$ -     | \$ 10,288 | \$ 10,288 |
| Other real estate owned | -       | -        | 501       | 501       |
| December 31,<br>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<br>September 30,<br>2013 | December 31,<br>2012 | Valuation<br>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<br>Amount | Fair<br>Value | Level I | Level II | Level III |
|--------------------|--------------------|---------------|---------|----------|-----------|
| Financial assets:  |                    |               |         |          |           |



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|   |            |            |            |         |         |
|---|------------|------------|------------|---------|---------|
| 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   |            | Level I    | Level II | Level III  |
|------------------------------------|------------|------------|------------|----------|------------|
|                                    | Amount     | Fair Value |            |          |            |
| <b>Financial assets:</b>           |            |            |            |          |            |
| 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      | -        | -          |
| <b>Financial liabilities:</b>      |            |            |            |          |            |
| 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<br>Balance<br>(1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% | Average<br>Balance<br>(1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% |
|---|---------------------------------|----------------|----------------------|---------------------------------|----------------|----------------------|
| <b>ASSETS</b>                               |                                 |                |                      |                                 |                |                      |
| 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                         |                |                      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                 |                |                      |                                 |                |                      |
| 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<br>Balance<br>(1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% | Average<br>Balance<br>(1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% |
| <b>ASSETS</b>                               |                                 |                |                      |                                 |                |                      |
| Short-term investments:                     |                                 |                |                      |                                 |                |                      |
| Interest-bearing deposits at banks          | 14,342                          | 6              | 0.16                 | 13,204                          | 5              | 0.15                 |
| Total short-term investments                | 14,342                          | 6              | 0.16                 | 13,204                          | 5              | 0.15                 |
| Interest bearing time deposits at banks     | 466                             | 2              | 2.02                 | -                               | -              | -                    |
| Investment securities:                      |                                 |                |                      |                                 |                |                      |
| Taxable                                     | 217,579                         | 928            | 1.70                 | 222,163                         | 1,102          | 1.98                 |
| Tax-exempt (3)                              | 93,542                          | 1,288          | 5.51                 | 93,999                          | 1,392          | 5.92                 |
| Total investment securities                 | 311,121                         | 2,216          | 2.96                 | 316,162                         | 2,494          | 3.16                 |
| Loans:                                      |                                 |                |                      |                                 |                |                      |
| Residential mortgage loans                  | 182,457                         | 2,751          | 5.98                 | 182,831                         | 2,926          | 6.36                 |
| Construction                                | 16,492                          | 201            | 4.85                 | 10,894                          | 155            | 5.66                 |
| Commercial & agricultural loans             | 252,580                         | 3,913          | 6.15                 | 236,734                         | 3,680          | 6.18                 |
| Loans to state & political subdivisions     | 59,778                          | 659            | 4.37                 | 58,504                          | 685            | 4.66                 |
| Other loans                                 | 9,753                           | 201            | 8.17                 | 10,342                          | 217            | 8.35                 |
| Loans, net of discount (2)(3)(4)            | 521,060                         | 7,725          | 5.88                 | 499,305                         | 7,663          | 6.11                 |
| Total interest-earning assets               | 846,989                         | 9,949          | 4.66                 | 828,671                         | 10,162         | 4.88                 |
| Cash and due from banks                     | 3,894                           |                |                      | 3,753                           |                |                      |
| Bank premises and equipment                 | 11,392                          |                |                      | 11,493                          |                |                      |
| Other assets                                | 28,333                          |                |                      | 30,256                          |                |                      |
| Total non-interest earning assets           | 43,619                          |                |                      | 45,502                          |                |                      |
| Total assets                                | 890,608                         |                |                      | 874,173                         |                |                      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                 |                |                      |                                 |                |                      |
| Interest-bearing liabilities:               |                                 |                |                      |                                 |                |                      |
| NOW accounts                                | 215,784                         | 204            | 0.38                 | 200,603                         | 192            | 0.38                 |



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|  |         |       |       |         |       |       |
|--|---------|-------|-------|---------|-------|-------|
| Savings accounts   | 92,702  | 37    | 0.16  | 85,168  | 42    | 0.20  |
| Money market accounts  | 90,655  | 111   | 0.49  | 74,370  | 75    | 0.40  |
| Certificates of deposit  | 269,978 | 927   | 1.36  | 290,174 | 1,177 | 1.61  |
| Total interest-bearing deposits  | 669,119 | 1,279 | 0.79  | 650,315 | 1,486 | 0.91  |
| Other borrowed funds   | 34,568  | 283   | 3.25  | 46,834  | 373   | 3.17  |
| Total interest-bearing liabilities                                     | 703,687 | 1,562 | 0.88  | 697,149 | 1,859 | 1.06  |
| Demand deposits  | 89,245  |       |       | 85,724  |       |       |
| Other liabilities  | 6,582   |       |       | 8,711   |       |       |
| Total non-interest-bearing liabilities                                 | 95,827  |       |       | 94,435  |       |       |
| Stockholders' equity   | 91,094  |       |       | 82,589  |       |       |
| Total liabilities & stockholders' equity                               | 890,608 |       |       | 874,173 |       |       |
| Net interest income  |         | 8,387 |       |         | 8,303 |       |
| Net interest spread (5)  |         |       | 3.78% |         |       | 3.82% |
| Net interest income as a percentage of average interest-earning assets |         |       | 3.93% |         |       | 3.99% |
| Ratio of interest-earning assets to interest-bearing liabilities       |         |       | 120%  |         |       | 119%  |

(1) Averages are based on daily averages.

(2) Includes loan origination and commitment fees.

(3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 34%.

(4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.

(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Tax exempt revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Company's 34% Federal statutory rate. The following table represents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the periods ending September 30, 2013 and 2012(in thousands):

|   | For the Three Months<br>Ended September 30 |          | For the Nine Months<br>Ended September 30 |           |
|---|--|----------|---|-----------|
|   | 2013                                       | 2012     | 2013                                      | 2012      |
| Interest and dividend income from investment securities   |  |          |   |           |
| and interest bearing deposits at banks (non-tax adjusted)   | \$ 1,786                                   | \$ 2,026 | \$ 5,455                                  | \$ 6,372  |
| Tax equivalent adjustment   | 438  | 473      | 1,320                                     | 1,439     |
| Interest and dividend income from investment securities and interest bearing deposits at banks (tax equivalent basis) | \$ 2,224                                   | \$ 2,499 | \$ 6,775                                  | \$ 7,811  |
| Interest and fees on loans (non-tax adjusted)   | \$ 7,521                                   | \$ 7,448 | \$ 21,799                                 | \$ 22,352 |
| Tax equivalent adjustment   | 204  | 215      | 630                                       | 619       |
| Interest and fees on loans (tax equivalent basis)   | \$ 7,725                                   | \$ 7,663 | \$ 22,429                                 | \$ 22,971 |
| Total interest income   | \$ 9,307                                   | \$ 9,474 | \$ 27,254                                 | \$ 28,724 |
| Total interest expense  | 1,562                                      | 1,859    | 4,845                                     | 5,886     |
| Net interest income   | 7,745                                      | 7,615    | 22,409                                    | 22,838    |
| Total tax equivalent adjustment   | 642  | 688      | 1,950                                     | 2,058     |
| Net interest income (tax equivalent basis)  | \$ 8,387                                   | \$ 8,303 | \$ 24,359                                 | \$ 24,896 |

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

|   | Three months ended September 30,<br>2013 vs. 2012 (1) |                   |                 | Nine months ended September<br>30, 2013 vs. 2012 (1) |                   |                 |
|---|---|-------------------|-----------------|--|-------------------|-----------------|
|   | Change<br>in<br>Volume                                | Change<br>in Rate | Total<br>Change | Change<br>in<br>Volume                               | Change<br>in Rate | Total<br>Change |
| Interest Income:                        |   |                   |                 |  |                   |                 |
| Short-term investments:                 |   |                   |                 |  |                   |                 |
| Interest-bearing deposits at banks      | \$ 1  | \$ -              | \$ 1            | \$ 7   | \$ 7              | \$ 14           |
| Interest bearing time deposits at banks | 2   | -                 | 2               | 2  | -                 | 2               |

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|   |        |          |       |        |            |          |
|---|--------|----------|-------|--------|------------|----------|
| Investment securities:                  |        |          |       |        |            |          |
| Taxable                                 | (23)   | (151)    | (174) | (267)  | (436)      | (703)    |
| Tax-exempt                              | (9)    | (95)     | (104) | (90)   | (259)      | (349)    |
| Total investments                       | (32)   | (246)    | (278) | (357)  | (695)      | (1,052)  |
| Loans:                                  |        |          |       |        |            |          |
| Residential mortgage loans              | (1)    | (174)    | (175) | (175)  | (507)      | (682)    |
| Construction                            | 71     | (25)     | 46    | 128    | (43)       | 85       |
| Commercial & farm loans                 | 256    | (23)     | 233   | 554    | (424)      | 130      |
| Loans to state & political subdivisions | 17     | (43)     | (26)  | 113    | (142)      | (29)     |
| Other loans                             | (11)   | (5)      | (16)  | (30)   | (16)       | (46)     |
| Total loans, net of discount            | 332    | (270)    | 62    | 590    | (1,132)    | (542)    |
| Total Interest Income                   | 303    | (516)    | (213) | 242    | (1,820)    | (1,578)  |
| Interest Expense:                       |        |          |       |        |            |          |
| Interest-bearing deposits:              |        |          |       |        |            |          |
| NOW accounts                            | 15     | (3)      | 12    | 22     | (38)       | (16)     |
| Savings accounts                        | 4      | (9)      | (5)   | 16     | (26)       | (10)     |
| Money Market accounts                   | 18     | 18       | 36    | 49     | 26         | 75       |
| Certificates of deposit                 | (89)   | (161)    | (250) | (264)  | (598)      | (862)    |
| Total interest-bearing deposits         | (52)   | (155)    | (207) | (177)  | (636)      | (813)    |
| Other borrowed funds                    | (99)   | 9        | (90)  | (342)  | 114        | (228)    |
| Total interest expense                  | (151)  | (146)    | (297) | (519)  | (522)      | (1,041)  |
| Net interest income                     | \$ 454 | \$ (370) | \$ 84 | \$ 761 | \$ (1,298) | \$ (537) |

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

Tax equivalent net interest income decreased from \$24,896,000 for the 2012 nine month period to \$24,359,000 in the 2013 nine month period, a decrease of \$537,000. The tax equivalent net interest margin decreased from 3.99% for the first nine months of 2012 to 3.89% in 2013.

Total tax equivalent interest income for the 2013 nine month period decreased \$1,578,000 as compared to the 2012 nine month period. This decrease was primarily a result of a decrease of \$1,820,000 due to a change in rate, as the yield on interest earning assets decreased from 4.94% to 4.67% or 27 basis points for the comparable periods. This decrease was offset by an increase of \$242,000 as a result of an increase in the average balance of interest earning assets of \$3.3 million for the comparable periods. While the Bank has been able to add interest earning assets, the new assets are priced at lower rates than assets that have matured due to the prolonged low interest rate environment. Additionally, assets repriced at lower rates during the current year.

Tax equivalent investment income for the nine months ended September 30, 2013 decreased \$1,052,000 over the same period last year. The average balance of total investment securities for the nine months ended September 30, 2013 decreased by \$20.3 million from September 30, 2012, as a result of a leveraging strategy implemented in the first part of 2012 whereby we purchased additional securities at higher interest rates than the overnight borrowings rate.

- The average balance of taxable securities decreased by \$18.3 million while tax-exempt securities decreased by \$2.0 million, which had the effect of decreasing interest income by \$267,000 and \$90,000, respectively, due to volume.
- The yield on investment securities decreased 25 basis points from 3.19% to 2.94%, which corresponds to a decrease in interest income of \$695,000. The majority of this decrease, \$436,000, is attributable to the change in yield on taxable securities, which experienced a decrease of 26 basis points from 2.05% to 1.79%. The remaining decrease of \$259,000 is attributable to the yield on tax-exempt securities decreasing from 5.99% to 5.62%. The yield on investments declined due to the amount of purchases we made in the current low interest rate environment. For a discussion of the Company's current investment strategy, see the "Financial Condition – Investments".

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

Total loan interest income decreased \$542,000 for the nine months ended September 30, 2013 compared to the same period last year.

- Interest income on residential mortgage loans decreased \$682,000 of which \$507,000 was due to rate and \$175,000 was due to decreased volume. The average balance decreased \$3.5 million due to the significant refinancing of qualifying mortgages that were sold on the secondary market in the last three quarters of 2012 and the first three quarters of 2013. The loans were sold to minimize future interest rate risk, while also being able to recognize a gain on the sale. The yield earned decreased from 6.46% to 6.08% due to the rate environment and increased competition.
- The average balance of commercial and agricultural loans increased \$14.9 million from a year ago as we continue to emphasize and strive for growth in this segment of the loan portfolio utilizing disciplined underwriting standards. This had a positive impact of \$554,000 on total interest income due to volume, which was offset by a decrease of \$424,000 due to rate, as the yield earned decreased from 6.27% to 5.97% due to the decreasing rate environment and increased competition.

Total interest expense decreased \$1,041,000 for the nine months ended September 30, 2013 compared with last year. This decrease is primarily due to changes in the certificate of deposit portfolio as the associated interest expense decreased \$862,000. The average interest rate on interest-bearing liabilities decreased 19 basis points, from 1.12% to .93%. The continued low interest rate environment prompted by the Federal Reserve and current economic conditions

had the effect of decreasing our short-term borrowing costs as well as rates on all deposit products. While the Company's rates on deposit products are below historical averages they are competitive with rates paid by other institutions in the marketplace. (See also "Financial Condition – Deposits").

- Interest expense on certificates of deposits decreased \$862,000 over the same period last year. There was a decrease in the average rate on certificates of deposit from 1.70% to 1.42% resulting in a decrease in interest expense of \$598,000. Additionally, the average balance of certificates of deposit decreased \$21.6 million causing a decrease in interest expense of \$264,000.
- Interest expense on other borrowed funds decreased \$228,000 over the same period last year. The average balance of other borrowed funds decreased \$13.9 million causing a decrease in interest expense of \$342,000. This decrease was offset by an increase the average rate on other borrowed funds of 25 basis points resulting in an increase in interest expense of \$114,000. The increase in rate on the other borrowed funds is a result of the leveraging strategy utilized in 2012 that resulted in a significant amount of overnight borrowings with a cost of 25 basis points.

Tax equivalent net interest income for the three months ended September 30, 2013 was \$8,387,000 which compares to \$8,303,000 for the same period last year. This represents an increase of \$84,000.

Total tax equivalent interest income was \$9,949,000 for the 2013 three month period ended September 30, 2013, compared with \$10,162,000 for the comparable period last year, a decrease of \$213,000. Of this amount, \$516,000 was a result of a decrease of 22 basis points on our yield on interest earning assets from 4.88% to 4.66%:

- Total investment income decreased by \$278,000 compared to same period last year. This was due to a \$5.0 million decrease in the average balance of investment securities, which resulted in a decrease in income of \$32,000, and a 20 point decrease in rate on investments from 3.16% to 2.96%, which equates to \$246,000.
- Total loan interest income increased \$62,000 compared to last year. This was predominantly due to a decrease in rate of 23 points from 6.11% to 5.88% offset by a change in volume as a result of a \$21.8 million increase in average loans outstanding. During the quarter, the Bank received \$304,000 of non-accrual interest income, which had a positive impact on the quarterly yield.

Total interest expense decreased \$297,000 for the three months ended September 30, 2013 compared with last year as a result of a decrease in the average rate on interest-bearing liabilities of 18 basis points from 1.06% to 0.88% accounting for a \$146,000 decrease in interest expense. Additionally, due to a \$20.2 million decrease in the average balance of certificates of deposit, there was an \$89,000 decrease in interest expense. The average balances of other borrowed funds decreased \$12.3 million for the 2013 period compared to 2012, which accounted for an additional decrease in interest expense of \$99,000.

#### Provision for Loan Losses

For each of the nine month periods ending September 30, 2013 and 2012, we recorded a provision for loan losses of \$315,000. While the Bank's loan portfolio grew during the 2013 period, the qualitative factors utilized in calculating the allowance have improved over the comparable periods. (See "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

For the three months ending September 30, 2013, we recorded a provision of \$90,000 compared to \$105,000 for the same period in 2012.

#### Non-interest Income

The following table shows the breakdown of non-interest income for the three and nine months ended September 30, 2013 and 2012 (in thousands):



|                                       | Nine months ended     |          | Change  |        |
|---------------------------------------|-----------------------|----------|---------|--------|
|                                       | September 30,<br>2013 | 2012     | Amount  | %      |
| Service charges                       | \$ 3,203              | \$ 3,346 | \$(143) | (4.3)  |
| Trust                                 | 539                   | 472      | 67      | 14.2   |
| Brokerage and insurance               | 333                   | 305      | 28      | 9.2    |
| Investment securities gains, net      | 385                   | 561      | \$(176) | (31.4) |
| Gains on loans sold                   | 236                   | 287      | \$(51)  | (17.8) |
| Earnings on bank owned life insurance | 377                   | 378      | \$(1)   | (0.3)  |
| Other                                 | 328                   | 342      | \$(14)  | (4.1)  |
| Total                                 | \$ 5,401              | \$ 5,691 | \$(290) | (5.1)  |

|                                       | Three months ended    |          | Change  |        |
|---------------------------------------|-----------------------|----------|---------|--------|
|                                       | September 30,<br>2013 | 2012     | Amount  | %      |
| Service charges                       | \$ 1,100              | \$ 1,139 | \$(39)  | (3.4)  |
| Trust                                 | 169                   | 148      | 21      | 14.2   |
| Brokerage and insurance               | 120                   | 80       | 40      | 50.0   |
| Investment securities gains, net      | 91                    | 240      | \$(149) | (62.1) |
| Gains on loans sold                   | 75                    | 102      | \$(27)  | (26.5) |
| Earnings on bank owned life insurance | 127                   | 128      | \$(1)   | (0.8)  |
| Other                                 | 124                   | 109      | 15      | 13.8   |
| Total                                 | \$ 1,806              | \$ 1,946 | \$(140) | (7.2)  |

Non-interest income for the nine months ended September 30, 2013 totaled \$5,401,000, a decrease of \$290,000 when compared to the same period in 2012. During the first nine months of 2013, investment security gains amounted to \$385,000 compared to gains of \$561,000 last year. During 2013, we sold eight mortgage backed securities that were repaying quickly for a net gain of \$104,000, four municipal securities for gains totaling \$87,000, four agency securities for gains totaling \$46,000 that were maturing later in 2013, portions of three financial institution equity holdings for gains totaling \$145,000 and a corporate obligation for a gain of \$2,000 due to favorable market conditions. During the comparable period in 2012, we sold four agency securities for gains totaling \$50,000, U.S. treasuries for a gain of \$95,000, eleven mortgage backed securities in government sponsored entities for gains totaling \$358,000, and a portion of a financial institution equity holding for a gain of \$58,000 due to favorable market conditions.

For the first nine months of 2013, account service charges totaled \$3,203,000, a decrease of \$143,000 or 4.3%, when compared to the same period in 2012. There was a decrease of \$51,000 which we believe is directly attributable to the implementation of certain regulations issued as part of the Durbin amendment, which resulted in lower fees being earned by the bank. ATM income decreased \$40,000 as a result of the slowdown in the development of the Marcellus Shale natural gas exploration activities, which has resulted in fewer workers being transferred to the area who utilize the Bank's ATMs. Finally, there was a \$27,000 decrease attributable to fees charged to customers for non-sufficient funds. Management continues to monitor regulatory changes associated with the Dodd-Frank Act to determine the level of impact that these regulations will have on the fees that the Company realizes.



The increase in trust revenues of \$67,000 from the prior year is primarily attributable to the increase in average assets for the year under management during the first nine months of 2013. In September 2013, a significant withdrawal of trust assets by a single customer accounted for the decrease in assets under management since December 2012. Gains on loans sold decreased \$51,000 for the nine months ended September 30, 2013 to \$236,000. The decrease is due to the slowdown in refinancing activity in 2013.

For the three month period ended September 30, 2013, the decreases experienced in service charges and gains on loans sold are consistent with the year to date decreases described above. The increase in brokerage revenue in the third quarter is primarily attributable to an increase in customer buy/sale transactions.

## Non-interest Expense

The following tables reflect the breakdown of non-interest expense for the three and nine months ended September 30, 2013 and 2012 (in thousands):

|                                | Nine months ended<br>September 30, |           | Change |        |
|--------------------------------|------------------------------------|-----------|--------|--------|
|                                | 2013                               | 2012      | Amount | %      |
| Salaries and employee benefits | \$ 8,456                           | \$ 8,126  | \$ 330 | 4.1    |
| Occupancy                      | 956                                | 928       | 28     | 3.0    |
| Furniture and equipment        | 372                                | 315       | 57     | 18.1   |
| Professional fees              | 604                                | 701       | (97)   | (13.8) |
| FDIC insurance                 | 337                                | 353       | (16)   | (4.5)  |
| Pennsylvania shares tax        | 548                                | 441       | 107    | 24.3   |
| Other                          | 3,301                              | 3,488     | (187)  | (5.4)  |
| Total                          | \$ 14,574                          | \$ 14,352 | \$ 222 | 1.5    |

|                                | Three months ended<br>September 30, |          | Change  |        |
|--------------------------------|-------------------------------------|----------|---------|--------|
|                                | 2013                                | 2012     | Amount  | %      |
| Salaries and employee benefits | \$ 2,856                            | \$ 2,705 | \$ 151  | 5.6    |
| Occupancy                      | 302                                 | 304      | (2)     | (0.7)  |
| Furniture and equipment        | 157                                 | 113      | 44      | 38.9   |
| Professional fees              | 187                                 | 209      | (22)    | (10.5) |
| FDIC insurance                 | 112                                 | 115      | (3)     | (2.6)  |
| Pennsylvania shares tax        | 183                                 | 115      | 68      | 59.1   |
| Other                          | 1,123                               | 1,398    | (275)   | (19.7) |
| Total                          | \$ 4,920                            | \$ 4,959 | \$ (39) | (0.8)  |

Non-interest expenses increased \$222,000 for the nine months ended September 30, 2013 compared to the same period in 2012. Salaries and employee benefits increased \$330,000 or 4.1%. Merit increases effective the beginning of 2013 and an increase in full time equivalent employees as part of implementing the Bank's strategic plan accounted for an increase in non-interest expenses of approximately \$297,000. Health insurance expenses have increased \$58,000 for the first nine months of 2013 compared to the same period in 2012.

Professional fees decreased by \$97,000 primarily due to the Bank's charter conversion from a national bank to a Pennsylvania chartered bank and trust company that was completed in 2012. Other expenses decreased \$187,000 primarily as a result of several items relating to the Bank's 2012 charter conversion, including, lower office and printing supplies of \$98,000 and a decrease in regulatory fees of \$67,000.

For the three months ended, September 30, 2013, salaries and employee benefits increased by \$151,000 due to the reasons described above, which include merit increases and increased headcount. Other expenses decreased \$275,000 as the result of several items, which include decreased ORE expenses of \$147,000 as a result of paying real estate taxes for a large loan relationship in 2012, office and printing supplies of \$68,000 as a result of the charter conversion,

and contributions of \$54,000 as the result of a contribution made in the third quarter of 2012.

#### Provision for Income Taxes

The provision for income taxes was \$2,842,000 for the nine month period ended September 30, 2013 compared to \$3,196,000 for the same period in 2012. The decrease is primarily attributable to a decrease in income before provision for income taxes of \$941,000. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 22.0% and 23.1% for the first nine months of 2013 and 2012, respectively, compared to the statutory rate of 34%.

For the three-months ended September 30, 2013, the provision for income taxes was \$1,029,000 compared to \$1,033,000 for the same period in 2012. Our effective tax rate was 22.7% and 23.8% for the three months ended September 30, 2013 and 2012, respectively, compared to the statutory rate of 34%.

We have invested in four limited partnership agreements that established low-income housing projects in our market areas. We anticipate recognizing an aggregate of \$1.5 million of tax credits over the next ten years, with an additional \$50,000 to be recognized during 2013.

### Financial Condition

Total assets were \$899.4 million at September 30, 2013, an increase of \$17.0 million, or 1.9% from \$882.4 million at December 31, 2012. Cash and cash equivalents decreased \$12.6 million or 47.8% to \$13.8 million. Investment securities increased to \$318.5 million and net loans increased 4.0% to \$515.3 million at September 30, 2013. Total deposits increased \$21.6 million to \$758.7 million since year-end 2012, while borrowed funds decreased \$3.0 million to \$43.2 million.

### Cash and Cash Equivalents

Cash and cash equivalents totaled \$13.8 million at September 30, 2013 compared to \$26.3 million at December 31, 2012, a decrease of \$12.5 million. The decrease in cash is primarily a result of an increase in net loans of \$19.6 million, which is discussed in more detail below and an increase in investments of \$8.2 million offset by the increase in deposits of \$21.6 million. Management actively measures and evaluates its liquidity through our Asset–Liability Committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, including the Bank’s core deposits, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

### Interest bearing time deposits with other banks

The Company purchased in the third quarter of 2013, \$2.5 million of interest bearing time deposits with other banks that are subject to FDIC insurance to diversify its cashflows into a different product with the potential for rising rates in the future. The time deposits have an average maturity of approximately five years and earn interest at a rate of approximately two percent.

### Investments

The following table shows the composition of the investment portfolio as of September 30, 2013 and December 31, 2012 (dollars in thousands):

|   | September 30, 2013 |      | December 31, 2012 |      |
|---|--------------------|------|-------------------|------|
|   | Amount             | %    | Amount            | %    |
| Available-for-sale:                             |                    |      |                   |      |
| U.S. agency securities                          | \$ 145,932         | 45.8 | \$ 127,234        | 41.0 |
| U.S. treasury securities                        | 11,480             | 3.6  | 4,947             | 1.6  |
| Obligations of state and political subdivisions | 97,164             | 30.5 | 100,875           | 32.5 |
| Corporate obligations                           | 19,909             | 6.3  | 22,109            | 7.1  |

|   |    |         |       |            |       |
|---|----|---------|-------|------------|-------|
| Mortgage-backed securities in government sponsored entities |    | 42,468  | 13.3  | 53,673     | 17.3  |
| Equity securities in financial institutions                 |    | 1,499   | 0.5   | 1,414      | 0.5   |
| Total   | \$ | 318,452 | 100.0 | \$ 310,252 | 100.0 |

|   | September 30, 2013/<br>December 31, 2012<br>Change |        |
|---|--|--------|
| (dollars in<br>thousands)                                   | Amount   | %      |
| Available-for-sale:   |  |        |
| U.S. agency securities                                      | \$ 18,698  | 14.7   |
| U.S. treasury securities                                    | 6,533  | 132.1  |
| Obligations of state and political subdivisions             | (3,711)  | (3.7)  |
| Corporate obligations                                       | (2,200)  | (10.0) |
| Mortgage-backed securities in government sponsored entities | (11,205)   | (20.9) |
| Equity securities in financial institutions                 | 85   | 6.0    |
| Total   | \$ 8,200   | 2.6    |

Our investment portfolio increased by \$8.2 million, or 2.6%, from December 31, 2012 to September 30, 2013. During 2013, we purchased approximately \$71.8 million of U.S. agency obligations, \$6.9 million of U.S. treasury securities, \$10.9 million of state and local obligations, \$1.7 million of corporate obligations and \$7.2 million of mortgage backed securities, which helped offset the \$11.6 million of principal repayments and \$52.7 million of calls and maturities that occurred during the nine month period. We also sold \$15.9 million of various securities at a gain of \$385,000. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio for the nine month period ending September 30, 2013 yielded 2.94% compared to 3.19% for the same period in 2012 on a tax equivalent basis.

As a result of the Federal Reserve's commitment to a low rate policy, investment yields are significantly below historical levels. As such, the Company's investment strategy in 2013 has been to achieve an acceptable yield, while limiting exposure to rising rates and increased duration. We believe this strategy, while having an impact on 2013 earnings, will enable us to reinvest cash flows in the next two to five years when we believe investment opportunities will potentially improve.

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

#### Loans

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The following table shows the composition of the loan portfolio as of September 30, 2013 and December 31, 2012 (dollars in thousands):

|  | September 30,<br>2013 |       | December 31,<br>2012 |       |
|--|-----------------------|-------|----------------------|-------|
|  | Amount                | %     | Amount               | %     |
| Real estate:                                 |                       |       |                      |       |
| Residential                                  | \$ 183,370            | 35.1  | \$ 178,080           | 35.4  |
| Commercial                                   | 175,533               | 33.6  | 176,710              | 35.2  |
| Agricultural                                 | 20,913                | 4.0   | 18,015               | 3.6   |
| Construction                                 | 18,272                | 3.5   | 12,011               | 2.4   |
| Consumer                                     | 9,979                 | 1.9   | 10,559               | 2.1   |
| Commercial<br>and other<br>loans             | 54,160                | 10.4  | 47,880               | 9.5   |
| State &<br>political<br>subdivision<br>loans | 60,105                | 11.5  | 59,208               | 11.8  |
| Total loans                                  | 522,332               | 100.0 | 502,463              | 100.0 |
| Less<br>allowance for<br>loan losses         | 7,070                 |       | 6,784                |       |
| Net loans                                    | \$ 515,262            |       | \$ 495,679           |       |

|  | September 30, 2013/<br>December 31, 2012 | Change |
|--|--|--------|
|  | Amount                                   | %      |
| Real estate:                                 |  |        |
| Residential                                  | \$ 5,290                                 | 3.0    |
| Commercial                                   | (1,177)                                  | (0.7)  |
| Agricultural                                 | 2,898                                    | 16.1   |
| Construction                                 | 6,261                                    | 52.1   |
| Consumer                                     | (580)                                    | (5.5)  |
| Commercial<br>and other<br>loans             | 6,280                                    | 13.1   |
| State &<br>political<br>subdivision<br>loans | 897                                      | 1.5    |
| Total loans                                  | \$ 19,869                                | 4.0    |

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

Total loans increased \$19.9 million or 4.0% during the first nine months of 2013. As can be seen in the table above, all loan categories with the exception of commercial real estate and consumer loans have experienced increases since December 31, 2012.

The Company is currently focused on growing commercial real estate, commercial and agricultural and state and political subdivision loans as a means to increase loan growth and obtain deposits from farmers, small businesses and municipalities throughout our market area. As part of this strategy, the Bank has opened two loan production offices, which resulted in additional loan growth in 2013. This focus resulted in loan growth in agricultural real estate of \$2.9 million, construction of \$6.3 million, commercial and other loans of \$6.3 million and \$900,000 of state and political subdivision loans. As a community bank, we strive to meet the unique needs and provide solutions to customers within our service area. Commercial real estate and other commercial loan demand are subject to significant competitive pressures, the yield curve, the strength of the overall regional and national economy and the local economy. The local economy is impacted significantly by the Marcellus Shale gas exploration activities, which are impacted by regulations and changes in the market price of natural gas. Due to the low price for natural gas throughout 2012, and 2013, exploration activities have been curtailed in comparison to 2011. Additionally, we work closely with local municipalities and school districts to meet their needs that otherwise would be provided by the municipal bond market.

During the first nine months of 2013, residential real estate loans increased \$5.3 million. Loan demand for conforming mortgages, which the Company typically sells on the secondary market, remained strong for the first nine months of 2013. During the first nine months of 2013, \$18.5 million of loans were sold on the secondary market, which compares to \$21.9 million for the comparable period in 2012. In addition, due to the decline in demand for non-conforming mortgages and the difficult investment environment, the Company decided during the first part of 2013 that certain 15 year mortgage loans that met secondary market standards would not be sold on the secondary



market, but would instead be held as part of the Bank's residential real estate portfolio. During the first nine months of 2013, the Company decided not to sell \$6.9 million of residential mortgages that met secondary market standards. For loans sold on the secondary market, the Company recognizes fee income for servicing these sold loans, which is included in non-interest income in the Consolidated Statement of Income. Management continues to look for ways to ensure that our customers choose the Company for their mortgage needs. This includes partnering with a third party to provide access to government supported loan programs sponsored by the Federal Housing Administration and the U.S. Department of Veteran Affairs and to implement technologies that improve customer service, by making it easier and more efficient for customers to obtain a mortgage.

## Allowance for Loan Losses

The allowance for loan losses is maintained at a level which in management's judgment is adequate to absorb probable future loan losses inherent in the loan portfolio. The provision for loan losses is charged against current income. Loans deemed not collectable are charged-off against the allowance while subsequent recoveries increase the allowance. The following table presents an analysis of the allowance for loan losses and non-performing loans and assets as of and for the nine months ended September 30, 2013 and for the years ended December 31, 2012, 2011, 2010 and 2009 (dollars in thousands):

|                                    | September<br>30,<br>2013 |         | December 31,<br>2011 |         | December 31,<br>2010 |         | 2009 |         |
|------------------------------------|--------------------------|---------|----------------------|---------|----------------------|---------|------|---------|
| Balance                            |                          |         |                      |         |                      |         |      |         |
| at beginning of period             | \$                       | 6,784   | \$                   | 6,487   | \$                   | 5,915   | \$   | 4,888   |
| Charge-offs:                       |                          |         |                      |         |                      |         |      |         |
| Real estate:                       |                          |         |                      |         |                      |         |      |         |
| Residential                        |                          | (15)    |                      | (95)    |                      | (101)   |      | (147)   |
| Commercial                         |                          | -       |                      | (2)     |                      | (29)    |      | (53)    |
| Agricultural                       |                          | -       |                      | -       |                      | -       |      | -       |
| Consumer                           |                          | (42)    |                      | (54)    |                      | (71)    |      | (35)    |
| Commercial and other loans         |                          | (1)     |                      | (21)    |                      | (6)     |      | (173)   |
| Total loans charged-off            |                          | (58)    |                      | (172)   |                      | (207)   |      | (408)   |
| Recoveries:                        |                          |         |                      |         |                      |         |      |         |
| Real estate:                       |                          |         |                      |         |                      |         |      |         |
| Residential                        |                          | 3       |                      | -       |                      | -       |      | 4       |
| Commercial                         |                          | -       |                      | 9       |                      | 15      |      | 11      |
| Agricultural                       |                          | -       |                      | -       |                      | -       |      | -       |
| Consumer                           |                          | 26      |                      | 33      |                      | 57      |      | 45      |
| Commercial and other loans         |                          | -       |                      | 7       |                      | 32      |      | 120     |
| Total loans recovered              |                          | 29      |                      | 49      |                      | 104     |      | 180     |
| Net loans charged-off              |                          | (29)    |                      | (123)   |                      | (103)   |      | (228)   |
| Provision charged to expense       |                          | 315     |                      | 420     |                      | 675     |      | 1,255   |
| Balance at end of year             | \$                       | 7,070   | \$                   | 6,784   | \$                   | 6,487   | \$   | 5,915   |
| Loans outstanding at end of period | \$                       | 522,332 | \$                   | 502,463 | \$                   | 487,509 | \$   | 473,517 |
| Average loans outstanding, net     | \$                       | 512,445 | \$                   | 496,822 | \$                   | 474,972 | \$   | 468,620 |
| Non-performing assets:             |                          |         |                      |         |                      |         |      |         |
|                                    | \$                       | 8,697   | \$                   | 8,067   | \$                   | 9,165   | \$   | 11,853  |
|                                    |                          |         |                      |         |                      |         |      | 5,871   |

|  |          |          |           |           |          |
|--|----------|----------|-----------|-----------|----------|
| Non-accruing loans   |          |          |           |           |          |
| Accrual loans - 90 days or more past due                           | 588      | 506      | 275       | 692       | 884      |
| Total non-performing loans   | \$ 9,285 | \$ 8,573 | \$ 9,440  | \$ 12,545 | \$ 6,755 |
| Foreclosed assets held for sale                                    | 501      | 616      | 860       | 693       | 302      |
| Total non-performing assets  | \$ 9,786 | \$ 9,189 | \$ 10,300 | \$ 13,238 | \$ 7,057 |
| Annualized net charge-offs to average loans                        | 0.01%    | 0.02%    | 0.02%     | 0.05%     | 0.09%    |
| Allowance to total loans   | 1.35%    | 1.35%    | 1.33%     | 1.25%     | 1.07%    |
| Allowance to total non-performing loans                            | 76.14%   | 79.13%   | 68.72%    | 47.15%    | 72.36%   |
| Non-performing loans as a percent of loans net of unearned income  | 1.78%    | 1.71%    | 1.94%     | 2.65%     | 1.48%    |
| Non-performing assets as a percent of loans net of unearned income | 1.87%    | 1.83%    | 2.11%     | 2.80%     | 1.55%    |

Management believes it uses the best information available when estimating the allowance for loan losses and that the allowance for loan losses is adequate as of September 30, 2013. However, future adjustments could be required if circumstances differ substantially from assumptions and estimates used in making the initial determination. A prolonged downturn in the economy, continued high unemployment rates, significant changes in the value of collateral and delays in receiving financial information from borrowers could result in increased levels of non-performing assets, charge-offs, loan loss provisions and reduction in income. Additionally, bank regulatory agencies periodically examine the Bank's allowance for loan losses. The banking agencies could require the recognition of additions to the allowance for loan losses based upon their judgment of information available to them at the time of their examination.

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

The balance in the allowance for loan losses was \$7,070,000 or 1.35% of total loans as of September 30, 2013 as compared to \$6,784,000 or 1.35% of loans as of December 31, 2012. The \$286,000 increase is a result of a \$315,000 provision for the first nine months less net charge-offs of \$29,000. Net charge-offs for all of 2012 were \$123,000. The following table shows the distribution of the allowance for loan losses and the percentage of loans compared to total loans by loan category (dollars in thousands) as of September 30, 2013 and December 31, 2012, 2011, 2010 and 2009:

|  | September 30,<br>2013 |       | 2012     |       | December 31<br>2011 |       | 2010     |       | 2009     |       |
|--|-----------------------|-------|----------|-------|---------------------|-------|----------|-------|----------|-------|
|  | Amount                | %     | Amount   | %     | Amount              | %     | Amount   | %     | Amount   | %     |
| Real estate<br>loans:                        |                       |       |          |       |                     |       |          |       |          |       |
| Residential                                  | \$ 956                | 35.1  | \$ 875   | 35.4  | \$ 805              | 37.7  | \$ 969   | 39.1  | \$ 801   | 42.7  |
| Commercial,<br>agricultural                  | 4,412                 | 37.6  | 4,437    | 38.8  | 4,132               | 37.9  | 3,380    | 36.2  | 2,864    | 33.6  |
| Construction                                 | 112                   | 3.5   | 38       | 2.4   | 15                  | 1.7   | 22       | 2.1   | 20       | 1.2   |
| Consumer                                     | 114                   | 1.9   | 119      | 2.1   | 111                 | 2.2   | 108      | 2.4   | 131      | 2.6   |
| Commercial<br>and other<br>loans             | 964                   | 10.4  | 728      | 9.5   | 674                 | 9.1   | 983      | 10.0  | 918      | 9.7   |
| State &<br>political<br>subdivision<br>loans | 313                   | 11.5  | 271      | 11.8  | 235                 | 11.4  | 137      | 10.1  | 93       | 10.1  |
| Unallocated                                  | 199                   | N/A   | 316      | N/A   | 515                 | N/A   | 316      | N/A   | 61       | N/A   |
| Total<br>allowance for<br>loan losses        | \$ 7,070              | 100.0 | \$ 6,784 | 100.0 | \$ 6,487            | 100.0 | \$ 5,915 | 100.0 | \$ 4,888 | 100.0 |

As a result of previous loss experiences and other risk factors utilized in determining the allowance, the Bank's allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 37.6% of the loan portfolio, 62.4% of the allowance is assigned to this segment of the

loan portfolio as these loans have more inherent risks than residential real estate or loans to state and political subdivisions.

The following table identifies amounts of loans contractually past due 30 to 89 days and non-performing loans by loan category, as well as the change from December 31, 2012 to September 30, 2013 in non-performing loans(dollars in thousands). Non-performing loans include those loans that are contractually past due 90 days or more and non-accrual loans. Interest does not accrue on non-accrual loans. Subsequent cash payments received are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of its ultimate ability to collect principal and interest.

|                            | September 30, 2013   |                  |             |                      | December 31, 2012    |                  |             |                      |
|----------------------------|----------------------|------------------|-------------|----------------------|----------------------|------------------|-------------|----------------------|
|                            | Non-Performing Loans |                  |             |                      | Non-Performing Loans |                  |             |                      |
|                            | 30 - 90              | 90 Days Past Due | Non-accrual | Total Non-Performing | 30 - 90              | 90 Days Past Due | Non-accrual | Total Non-Performing |
|                            | Days Past Due        |                  |             |                      | Days Past Due        |                  |             |                      |
| Real estate:               |                      |                  |             |                      |                      |                  |             |                      |
| Residential                | \$ 1,633             | \$ 289           | \$ 701      | \$ 990               | \$ 1,108             | \$ 332           | \$ 663      | \$ 995               |
| Commercial                 | 1,115                | 299              | 7,521       | 7,820                | 597                  | 152              | 7,042       | 7,194                |
| Agricultural               | 125                  | -                | -           | -                    | 54                   | -                | -           | -                    |
| Construction               | -                    | -                | -           | -                    | -                    | -                | -           | -                    |
| Consumer                   | 47                   | -                | 15          | 15                   | 87                   | 4                | -           | 4                    |
| Commercial and other loans | 17                   | -                | 460         | 460                  | 932                  | 18               | 362         | 380                  |
| Total nonperforming loans  | \$ 2,937             | \$ 588           | \$ 8,697    | \$ 9,285             | \$ 2,778             | \$ 506           | \$ 8,067    | \$ 8,573             |

|                            | Change in Non-Performing Loans         |          |
|----------------------------|--|----------|
|                            | September 30, 2013 / December 31, 2012 | Amount % |
| Real estate:               |  |          |
| Residential                | \$ (5)                                 | (0.5)    |
| Commercial                 | 626                                    | 8.7      |
| Agricultural               | -                                      | N/A      |
| Construction               | -                                      | N/A      |
| Consumer                   | 11                                     | 275.0    |
| Commercial and other loans | 80                                     | 21.1     |
| Total nonperforming loans  | \$ 712                                 | 8.3      |

For the nine month period ending September 30, 2013, we recorded a provision for loan losses of \$315,000, which compares to \$315,000 for the same time period in 2012. Non-performing loans increased \$712,000 or 8.3%, from December 31, 2012 to September 30, 2013. The increase was primarily attributable to one customer with a total relationship of approximately \$584,000 being placed on non-accrual status during 2013. Approximately 72.0% of the Bank's non-performing loans are associated with the following four customer relationships:

- A commercial customer with a total loan relationship of \$4.2 million secured by 164 residential properties was considered non-accrual as of September 30, 2013. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. As a result of all loan payments being made on the loans through September 30, 2013, there is no specific reserve allocation as of September 30, 2013 and the loan continues to pay in accordance with the restructured agreement. During the first nine months of 2013, the Bank updated a sample of appraised values of the collateral associated with this relationship and performed other reviews to ensure that there was not a significant change in the collateral values. This review did not identify any significant changes in

the collateral and as a result, the Bank believes that the loan is well collateralized. In July of 2013, the customer filed for bankruptcy under Chapter 11. We are evaluating what if any impact this will have on the collateral and on the loan payments.

- A commercial customer with a relationship of approximately \$969,000 was considered non-accrual as of September 30, 2013. \$669,000 of the relationship is subject to USDA guarantees. The current economic conditions related to the timber industry have significantly impacted the cash flows from the customer's activities. Management reviewed the collateral and guarantees and determined that a specific reserve allocation of \$113,000 was required as of September 30, 2013 based on the appraised value of collateral.
- A commercial customer with a relationship of approximately \$936,000 secured by real estate was considered non-accrual as of September 30, 2013. The current economic conditions have significantly impacted the cash flows from the customer's activities. Management reviewed the collateral and determined that a specific reserve allocation of \$221,000 was required as of September 30, 2013 based on the appraised value of collateral.
- A commercial customer with a relationship of approximately \$584,000 secured by real estate was considered non-accrual as of September 30, 2013. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer. Management reviewed the collateral and determined that a specific reserve allocation of \$52,000 was required as of September 30, 2013 based on the appraised value of collateral.

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

- While non-performing loans are still higher than the Company's historical levels, 45.2% of this balance is associated with one customer, whose debt is current through September 30, 2013.
- Net and gross charge-offs continue to be low in relation to the size of the Bank's loan portfolio and compared to our peer group.
  - We have not experienced the significant decrease in the collateral values of local residential, commercial or agricultural real estate loan portfolios as seen in other parts of the country. Additionally, our market area is predominately centered in the Marcellus Shale natural gas exploration and drilling area. These natural gas exploration and drilling activities have significantly impacted the overall interest in real estate in our market area due to the related lease and royalty revenues associated with it. The natural gas activities have had a positive impact on the value of local real estate.

#### Bank Owned Life Insurance

The Company purchased bank owned life insurance to offset future employee benefit costs. As of September 30, 2013, the cash surrender value of this life insurance is \$14,554,000, which has resulted in income recognized in the first nine months ended September 30, 2013 of \$377,000 compared to \$378,000 during the comparable period in 2012. The use of life insurance policies provides the Bank with an asset that will generate earnings to partially offset the current costs of benefits and eventually (at the death of the individuals) provides partial recovery of cash outflows associated with the benefits.

#### Premises and Equipment

Premises and equipment decreased from \$11.5 million at December 31, 2012 to \$11.3 million at September 30, 2013. This occurred primarily as a result of depreciation for 2013 of \$454,000 offset by purchases totaling approximately \$192,000.

#### Deposits

The following table shows the composition of deposits as of September 30, 2013 and December 31, 2012 (dollars in thousands):

|                               | September 30,<br>2013 |       | December 31,<br>2012 |       |
|-------------------------------|-----------------------|-------|----------------------|-------|
|                               | Amount                | %     | Amount               | %     |
| Non-interest-bearing deposits | \$ 89,716             | 11.8  | \$ 89,494            | 12.1  |
| NOW accounts                  | 216,643               | 28.5  | 201,804              | 27.4  |
| Savings deposits              | 93,261                | 12.3  | 87,836               | 11.9  |
| Money market deposit accounts | 90,770                | 12.0  | 83,423               | 11.3  |
| Certificates of deposit       | 268,266               | 35.4  | 274,539              | 37.3  |
| Total                         | \$ 758,656            | 100.0 | \$ 737,096           | 100.0 |



|                               | September 30, 2013/<br>December 31, 2012 |       |
|-------------------------------|--|-------|
|                               | Change                                   |       |
|                               | Amount                                   | %     |
| Non-interest-bearing deposits | \$ 222                                   | 0.2   |
| NOW accounts                  | 14,839                                   | 7.4   |
| Savings deposits              | 5,425                                    | 6.2   |
| Money market deposit accounts | 7,347                                    | 8.8   |
| Certificates of deposit       | (6,273)                                  | (2.3) |
| Total                         | \$ 21,560                                | 2.9   |

Deposits increased \$21.6 million since December 31, 2012. The biggest increase was in NOW accounts, with the majority related to state and political organizations, which received additional impact fee funds associated with the exploration for natural gas in the Marcellus Shale. These funds are collected by the State of Pennsylvania and subsequently disbursed to other political organizations twice a year. Additionally, we believe that our historical financial performance, reputation as a strong, local community bank, acquisitions of local competitors from institutions outside of our general market area and our focus on developing relationships with the local municipalities has positioned the Company as a leading financial institution within our service area with the ability to meet our customers' needs and expectations.

Similar to the prior year, as CD's mature, customers are converting the balances to other interest bearing deposits at the bank, including NOW accounts, savings accounts and money market accounts. This is occurring as customers want to retain more liquid deposits during this low rate environment. The Bank currently does not have any outstanding brokered certificates of deposit.

#### Borrowed Funds

Borrowed funds decreased \$3.0 million during the first nine months of 2013. The decrease was the result of repaying \$10.8 million of maturing terms notes from the FHLB and a decrease of \$1.1 million in the balances outstanding under repurchase agreements. The decreases were offset by an increase in overnight borrowings of \$8.9 million as of September 30, 2013. The Bank's current strategy for borrowings is to consider replacing any maturities with seven to ten year term borrowings due to the current interest rate environment, while considering loan and investment opportunities and the Bank's current liquidity position. As a result of the rise in rates in the third quarter, the Company borrowed funds overnight instead of obtaining long-term borrowings to fund the loan and investment growth that occurred in excess of deposit growth. The Company's daily cash requirements or short-term investments are primarily met by using the financial instruments available through the Federal Home Loan Bank of Pittsburgh.

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

at the initial investment amount and is included in the other assets section of the balance sheet. The Entity is not consolidated as part of the Company's consolidated financial statements.

In December, 2008, the Company entered into an interest rate swap agreement to convert the above mentioned floating-rate debt to fixed rate debt on a notional amount of \$7.5 million. The interest rate swap instrument involves an agreement to receive a floating rate and pay a fixed rate, at specified intervals, calculated on the agreed-upon notional amount. The differentials paid or received on interest rate swap agreements are recognized as adjustments to interest expense in the period. The interest rate swap agreement was entered into on December 17, 2008 and expires December 17, 2013. The fair value of the interest rate swap at September 30, 2013 was a liability of \$46,000 and is included within other liabilities on the Consolidated Balance Sheet.

## Stockholder's Equity

We evaluate stockholders' equity in relation to total assets and the risks associated with those assets. The greater the capital resource, the more likely a corporation will meet its cash obligations and absorb unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance. As such, the Company has implemented policies and procedures to ensure that it has adequate capital levels. As part of this process, we routinely stress test our capital levels and identify potential risk and alternative sources of additional capital should the need arise.

Total stockholders' equity was \$90.4 million at September 30, 2013 compared to \$89.5 million at December 31, 2012, an increase of \$905,000 or 1.0%. Excluding accumulated other comprehensive income (loss) stockholder's equity increased \$6.4 million, or 7.5%. The Company purchased 26,842 shares of treasury stock at a weighted average cost of \$47.75 per share, of which 3,600 shares were reissued in 2013, and purchased 3,027 shares that were awarded as part of the restricted stock plan at a weighted average cost of \$48.21. In the first nine months of 2013, the Company had net income of \$10.1 million and paid dividends of \$2.5 million, representing a cash dividend payout ratio of 25.2%. Not included in the dividends above, the Board of Directors accelerated the normal first quarter dividend of 2013 into 2012 due to the significant issues in Washington regarding the very complex fiscal cliff tax issues at the end of 2012 and its intent was to benefit shareholders that may have been affected by the potential tax increase on dividends during 2013. The accelerated dividend totaled \$1,101,000. We also issued a five percent stock dividend to the Company's shareholders, which had a market value of \$7.2 million at its issuance.

All of the Company's investment securities are classified as available-for-sale, making this portion of the Company's balance sheet more sensitive to the changing market value of investments. As a result of the rise in long term interest rates in the third quarter of 2013, accumulated other comprehensive income (loss) associated with the change in investment securities decreased \$5.7 million from December 31, 2012 and accounts for the majority of the total change in accumulated other comprehensive income of \$5.4 million.

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

|  | September 30,<br>2013 |        | December 31,<br>2012 |        |
|--|-----------------------|--------|----------------------|--------|
|  | Amount                | Ratio  | Amount               | Ratio  |
| Total capital (to risk-weighted assets)  |                       |        |                      |        |
| Company                                  | \$ 97,831             | 18.10% | \$ 90,889            | 17.50% |
| For capital adequacy purposes            | 43,248                | 8.00%  | 41,546               | 8.00%  |
| To be well capitalized                   | 54,060                | 10.00% | 51,932               | 10.00% |
| Tier I capital (to risk-weighted assets) |                       |        |                      |        |
| Company                                  | \$ 90,755             | 16.79% | \$ 84,166            | 16.21% |
| For capital adequacy purposes            | 21,624                | 4.00%  | 20,773               | 4.00%  |

|  |           |        |           |       |
|--|-----------|--------|-----------|-------|
| T o b e w e l l<br>capitalized           | 32,436    | 6.00%  | 31,159    | 6.00% |
| Tier I capital (to<br>average assets)    |           |        |           |       |
| Company                                  | \$ 90,755 | 10.29% | \$ 84,166 | 9.70% |
| F o r c a p i t a l<br>adequacy purposes | 35,278    | 4.00%  | 34,692    | 4.00% |
| T o b e w e l l<br>capitalized           | 44,097    | 5.00%  | 43,366    | 5.00% |

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

|  | September 30,<br>2013 |        | December 31,<br>2012 |        |
|--|-----------------------|--------|----------------------|--------|
| Total capital (to<br>risk-weighted<br>assets)  | Amount                | Ratio  | Amount               | Ratio  |
| Bank   | \$ 95,372             | 17.70% | \$ 87,215            | 16.84% |
| For capital<br>adequacy purposes               | 43,100                | 8.00%  | 41,425               | 8.00%  |
| To be well<br>capitalized                      | 53,875                | 10.00% | 51,781               | 10.00% |
| Tier I capital (to<br>risk-weighted<br>assets) |                       |        |                      |        |
| Bank   | \$ 88,518             | 16.43% | \$ 80,702            | 15.59% |
| For capital<br>adequacy purposes               | 21,550                | 4.00%  | 20,713               | 4.00%  |
| To be well<br>capitalized                      | 32,325                | 6.00%  | 31,069               | 6.00%  |
| Tier I capital (to<br>average assets)          |                       |        |                      |        |
| Bank   | \$ 88,518             | 10.05% | \$ 80,702            | 9.32%  |
| For capital<br>adequacy purposes               | 35,224                | 4.00%  | 34,634               | 4.00%  |
| To be well<br>capitalized                      | 44,029                | 5.00%  | 43,293               | 5.00%  |

#### Off Balance Sheet Activities

Some financial instruments, such as loan commitments, credit lines, and letters of credit are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at September 30, 2013 (in thousands):

|                                    |          |
|------------------------------------|----------|
| Commitments<br>to extend<br>credit | \$90,233 |
| Standby<br>letters of<br>credit    | 6,098    |
|                                    | \$96,331 |

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing. Overdraft charges as a result of ATM withdrawals and one time point of sale (non-recurring) transactions require prior approval of the customer. The non-contractual amount of financial instruments with off-balance sheet risk at September 30, 2013 was \$12,625,000. The Company reserves the right to discontinue this service without prior notice.

## Liquidity

Liquidity is a measure of the Company's ability to efficiently meet normal cash flow requirements of both borrowers and depositors. To maintain proper liquidity, we use funds management policies, which include liquidity target ratios, along with our investment policies to assure we can meet our financial obligations to depositors, credit customers and stockholders. Liquidity is needed to meet depositors' withdrawal demands, extend credit to meet borrowers' needs, provide funds for normal operating expenses and cash dividends, and to fund other capital expenditures.

Cash generated by operating activities, investing activities and financing activities influences liquidity management. Our Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows. The most important source of funds is core deposits. Repayment of principal on outstanding loans and cash flows created from the investment portfolio are also factors in liquidity management. Other sources of funding include brokered certificates of deposit and the sale of loans or investments, if needed.

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other significant uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures, during the first nine months of 2013 were \$339,000, compared to \$179,000 during the same time period in 2012.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short-term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$246.3 million, of which \$28.1 million was outstanding at September 30, 2013. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon. We also have a borrower in custody line with the Federal Reserve Bank of approximately \$13.7 million, which also is not drawn upon as of September 30, 2013. The Company continues to evaluate its liquidity needs and as necessary finds additional sources.

Citizens Financial Services, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial's primary source of income is dividends received from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. In particular, the Bank may not, as a state-chartered bank which is a member of the Federal Reserve System, declare a dividend without approval of the Federal Reserve, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At September 30, 2013, Citizens Financial Services, Inc. had liquid assets of \$1.3 million.

### Interest Rate and Market Risk Management

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

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk and, since our Company has no trading portfolio, it is not subject to trading risk. Currently, our Company has equity securities that represent only .5% of our investment portfolio and, therefore, equity risk is not significant.

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

Gap analysis, one of the methods used by us to analyze interest rate risk, does not necessarily show the precise impact of specific interest rate movements on our Company's net interest income because the re-pricing of certain assets and liabilities is discretionary and is subject to competitive and other pressures. In addition, assets and liabilities within the same period may, in fact, be repaid at different times and at different rate levels. We have not experienced the kind of earnings volatility that might be indicated from gap analysis.

Our Company currently uses a computer simulation model to better measure the impact of interest rate changes on net interest income. We use the model as part of our risk management process that will effectively identify, measure, and monitor our Company's risk exposure. We use numerous interest rate simulations employing a variety of assumptions to evaluate our interest rate risk exposure. Various analyses performed in the third quarter of 2013 ranging from a decrease in interest rates of 100 basis points to an increase in interest rates of 500 basis points result in variances over the next twelve to twenty four months that are within policy risk limits set by the Company's Board of Directors.

### Item 3-Quantitative and Qualitative Disclosure about Market Risk

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

Rate and Market Risk Management”).

49

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No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the SEC Form 10-K for the period ended December 31, 2012.

#### Item 4-Control and Procedures

##### (a) Disclosure Controls and Procedures

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

##### (b) Changes to Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended September 30, 2013 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

## PART II - OTHER INFORMATION

#### Item 1 - Legal Proceedings

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

#### Item 1A – Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission on March 27, 2012. Except as set forth below, as of September 30, 2013, the risk factors of the Company have not changed materially from those disclosed in our Annual Report on Form 10-K.

The short-term and long-term impact of the changing regulatory capital requirements and new capital rules are uncertain.

In July 2013, the Office of the Comptroller of the Currency and the Federal Reserve Board approved a new rule that will substantially amend the regulatory risk-based capital rules applicable to the Bank and the Company. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The final rule includes new minimum risk-based capital and leverage ratios, which will be effective for the Bank and the Company on January 1, 2015, and refines the definition of what constitutes "capital" for purposes of calculating

these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also revises the rules for calculating risk-weighted assets to enhance their risk sensitivity. The final rule also establishes a “capital conservation buffer” of 2.5% above the new regulatory minimum capital ratios, and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 to risk-based assets capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. As a result, under the new rules, if the Bank fails to maintain the buffer, the Company will be subject to limits, and possibly prohibitions, on its ability to obtain capital distributions from Bank. If the Company does not receive sufficient cash dividends from the Bank, then the Company may not have sufficient funds to pay dividends on its common stock, service its debt obligations, if any, or repurchase its common stock. In addition, if the Bank fails to maintain the buffer, the Company may be limited in its ability to pay certain cash bonuses to its executive officers which may make it more difficult to retain key personnel.

The application of more stringent capital requirements for the Bank and the Company could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions such as limitations or prohibitions on the ability to pay dividends, repurchase shares or pay discretionary bonuses. While we are continuing to review the impact of the new rules, there can be no assurance that they will not have a material impact on our business, financial condition and results of operations.

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

### ISSUER PURCHASES OF EQUITY SECURITIES

| Period            | Total Number of Shares (or units Purchased) | Average Price Paid per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1) |
|-------------------|---|--|---|---|
| 7/1/13 to 7/31/13 | -   | \$0.00                                 | -   | 114,821   |
| 8/1/13 to 8/31/13 | 8,341                                       | \$47.39                                | 8,341   | 106,480   |
| 9/1/13 to 9/30/13 | 13,700                                      | \$47.90                                | 13,700  | 92,780  |
| Total             | 22,041                                      | \$47.71                                | 22,041  | 92,780  |

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

## Item 3 - Defaults Upon Senior Securities

Not applicable.

## Item 4 – Mine Safety Disclosure

Not applicable.

## Item 5 - Other Information

None

## Item 6 - Exhibits

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

3.1 Articles of Incorporation of Citizens Financial Services, Inc., as amended (1)

3.2 Bylaws of Citizens Financial Services, Inc.(2)

51

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4.1 Form of Common Stock Certificate.(3)

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer

101 The following materials from the Company's Quarterly Report on Form 10-Q for the period ended September  
\*\* 30, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) The Consolidated Balance Sheet  
(unaudited), (ii) the Consolidated Statement of Income (unaudited), (iii) the Consolidated Statement of  
Comprehensive Income (unaudited), (iv) the Consolidated Statement of Cash Flows (unaudited) and (v)  
related notes (unaudited).

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

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

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

\*\* Furnished, not filed.

Signatures

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

Citizens Financial Services, Inc.

November 7, 2013

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

Company Name

November 7, 2013

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

