CITIZENS FINANCIAL SERVICES INC
Form 10-K
March 06, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 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 000-13222

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

Pennsylvania	23-2265045
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)

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

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $1.00 per share
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required 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 website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check one):

Large accelerated filer o | Accelerated filer

Non-accelerated filer o | Smaller reporting company o

(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 Act).
Yes No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. $132,608,894 as of June 30, 2013.

As of February 21, 2014, there were 3,019,134 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Part III is incorporated by reference to the Registrant's Definitive Proxy Statement for the 2014 Annual Meeting of Shareholders.

Citizens Financial Services, Inc.
Form 10-K
INDEX

PART I

ITEM 1 – BUSINESS.

CITIZENS FINANCIAL SERVICES, INC.

Citizens Financial Services, Inc. (the "Company"), a Pennsylvania corporation, was incorporated on April 30, 1984 to be the holding company for First Citizens Community Bank (the "Bank"), which until 2012, and in connection with its conversion from a national bank to a Pennsylvania-chartered bank and trust company, operated under the name First Citizens National Bank. The Company is primarily engaged in the ownership and management of the Bank and the Bank's wholly-owned insurance agency subsidiary, First Citizens Insurance Agency, Inc.

AVAILABLE INFORMATION

A copy of the Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current events reports on Form 8-K, and amendments to these reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge through the Company's web site at www.firstcitizensbank.com as soon as reasonably practicable after such reports are filed with the Securities and Exchange Commission. Information on our website shall not be considered as incorporated by reference into this Form 10-K.

FIRST CITIZENS COMMUNITY BANK

The Bank is a full-service bank engaged in a broad range of banking activities and services for individual, business, governmental and institutional customers. These activities and services principally include checking, savings, time and deposit accounts; residential, commercial and agricultural real estate, commercial and industrial, state and political subdivision and consumer loans; and a variety of other specialized financial services. The Trust and Investment division of the Bank offers a full range of client investment, estate, mineral management and retirement services.

The Bank's main office is located at 15 South Main Street, Mansfield, (Tioga County) Pennsylvania. The Bank's primary market area consists of the Pennsylvania Counties of Bradford, Potter and Tioga in north central Pennsylvania. It also includes Allegany, Steuben, Chemung and Tioga Counties in Southern New York. The economy of the Bank's market area is diversified and includes manufacturing industries, wholesale and retail trade, service industries, family farms and the production of natural resources of gas and timber. We are dependent geographically upon the economic conditions in north central Pennsylvania and the southern tier of New York. In addition to the main office, the Bank has 16 other full service branch offices in its market area and two loan production offices located in Clinton and Luzerne Counties in Pennsylvania.

As of December 31, 2013, the Bank had 169 full time employees and 31 part-time employees, resulting in 186 full time equivalent employees at our corporate offices and other banking locations.

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. Mortgage banking firms, financial companies, financial affiliates of industrial companies, brokerage firms, retirement fund management firms and government sponsored agencies, such as Freddie Mac and Fannie Mae, 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.

Additional information related to our business and competition is included in Part II, Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations”.

SUPERVISION AND REGULATION

GENERAL

The Bank is subject to extensive regulation, examination and supervision by the Pennsylvania Banking Department ("PBD") and, as a member of the Federal Reserve System, by the Board of Governors of the Federal Reserve System (the "FRB"). Federal and state banking laws and regulations govern, among other things, the scope of a bank's business, the investments a bank may make, the reserves against deposits a bank must maintain, terms of deposit accounts, loans a bank makes, the interest rates a bank charges and collateral a bank takes, the activities of a bank with respect to mergers and consolidations and the establishment of branches. The Company is registered as a bank holding company and is subject to supervision and regulation by FRB under the Bank Holding Company Act of 1956, as amended (the "BHCA").

PENNSYLVANIA BANKING LAWS

The Pennsylvania Banking Code ("Banking Code") contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PBD so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices.

Pennsylvania law also provides Pennsylvania state chartered institutions elective parity with the power of national banks, federal thrifts, and state-chartered institutions in other states as authorized by the FDIC, subject to a required notice to the PBD. The Federal Deposit Insurance Corporation Act ("FDIA"), however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless (1) the FDIC determines the activity or investment does not pose a significant risk of loss to the Deposit Insurance Fund and (2) the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is restricted by the FDIA.

In April 2008, banking regulators in the States of New Jersey, New York, and Pennsylvania entered into a Memorandum of Understanding (the "Interstate MOU") to clarify their respective roles, as home and host state regulators, regarding interstate branching activity on a regional basis pursuant to the Riegle-Neal Amendments Act of 1997. The Interstate MOU establishes the regulatory responsibilities of the respective state banking regulators regarding bank regulatory examinations and is intended to reduce the regulatory burden on state chartered banks branching within the region by eliminating duplicative host state compliance exams. Under the Interstate MOU, the activities of branches we established in New York would be governed by Pennsylvania state law to the same extent that federal law governs the activities of the branch of an out-of-state national bank in such host states. Issues regarding whether a particular host state law is preempted are to be determined in the first instance by the PBD. In the event that the PBD and the applicable host state regulator disagree regarding whether a particular host state law is pre-empted, the PBD and the applicable host state regulator would use their reasonable best efforts to consider all points of view and to resolve the disagreement.

COMMUNITY REINVESTMENT ACT

The Community Reinvestment Act, ("CRA"), as implemented by FRB regulations, provides that the Bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the FRB, in connection with its examination of the Bank, to assess the institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain corporate applications by such institution, such as mergers and branching. The Bank's most recent rating was "Satisfactory." Various consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the FRB as it attempts to control the money supply and credit availability in order to influence the economy.

THE DODD-FRANK ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) has significantly changed the current bank regulatory structure and will affect into the immediate future the lending and investment activities and general operations of depository institutions and their holding companies.

The Dodd-Frank Act requires the FRB to establish minimum consolidated capital requirements for bank holding companies that are as stringent as those required for insured depository institutions; the components of Tier 1 capital would be restricted to capital instruments that are currently considered to be Tier 1 capital for insured depository institutions. In addition, the proceeds of trust preferred securities are excluded from Tier 1 capital unless (i) such securities are issued by bank holding companies with assets of less than $500 million or (ii) such securities were issued prior to May 19, 2010 by bank or savings and loan holding companies with less than $15 billion of assets. The exclusion of such proceeds will be phased in over a three year period beginning in 2013.

The Dodd-Frank Act also created a new Consumer Financial Protection Bureau with extensive powers to implement and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rulemaking authority for a wide range of consumer protection laws that apply to all banks, among other things, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. However, institutions of less than $10 billion in assets, such as the Bank, will continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their prudential regulators.

The Dodd-Frank Act created a new supervisory structure for oversight of the U.S. financial system, including the establishment of a new council of regulators, the Financial Stability Oversight Council, to monitor and address systemic risks to the financial system. Non-bank financial companies that are deemed to be significant to the stability of the U.S. financial system and all bank holding companies with $50 billion or more in total consolidated assets will be subject to heightened supervision and regulation. The FRB will implement prudential requirements and prompt corrective action procedures for such companies.

The Dodd-Frank Act made many other changes in banking regulation. Those include allowing depository institutions, for the first time, to pay interest on business checking accounts, requiring originators of securitized loans to retain a percentage of the risk for transferred loans, establishing regulatory rate-setting for certain debit card interchange fees and establishing a number of reforms for mortgage originations. Effective October 1, 2011, the debit-card interchange fee was capped at $0.21 per transaction, plus an additional 5 basis point charge to cover fraud losses. These fees are much lower than the current market rates. Although the regulation only impacts banks with assets above $10 billion, we believe that the provisions could result in a reduction in interchange revenue in the future.

The Dodd-Frank Act also broadened the base for FDIC insurance assessments. The FDIC was required to promulgate rules revising its assessment system so that it is based on the average consolidated total assets less tangible equity capital of an insured institution instead of deposits. That rule took effect April 1, 2011. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008.

Under provisions of the Dodd-Frank Act referred to as the “Volcker Rule” certain limitations are placed on the ability of bank holding companies and their affiliates to engage in sponsoring, investing in and transacting with certain investment funds, including hedge funds and private equity funds (collectively “covered funds”). The Volcker Rule also places restrictions on proprietary trading, which could impact certain hedging activities. The Volcker Rule becomes fully effective in July 2015. We do not expect this rule to have a material impact on the Company.

Many of the provisions of the Dodd-Frank Act are not yet effective, and the Dodd-Frank Act requires various federal agencies to promulgate numerous and extensive implementing regulations over the next several years. It is therefore difficult to predict at this time what impact the Dodd-Frank Act and implementing regulations will have on the Company and the Bank. Although the substance and scope of many of these regulations cannot be determined at this time, particularly those provisions relating to the new Consumer Financial Protection Bureau, the Dodd-Frank Act and implementing regulations may have a material impact on operations through, among other things, increased compliance costs, heightened regulatory supervision, and higher interest expense.

CURRENT CAPITAL REQUIREMENTS

Federal banking agencies have issued certain “risk-based capital” guidelines, which supplemented existing capital requirements. In addition, the FRB imposes certain “leverage” requirements on member banks such as us. Banking regulators have authority to require higher minimum capital ratios for an individual bank or bank holding company in view of its circumstances.

The risk-based guidelines require all banks and bank holding companies to maintain two “risk-weighted assets” ratios. The first is a minimum ratio of total capital (Tier 1 and Tier 2 capital) to risk-weighted assets equal to 8.0%; the second is a minimum ratio of Tier 1 capital to risk-weighted assets equal to 4.0%. Assets are assigned to five risk categories, with higher levels of capital being required for the categories perceived as representing greater risk. In making the calculation, certain intangible assets must be deducted from the capital base. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets.

The risk-based capital rules also account for interest rate risk. Institutions with interest rate risk exposure above a normal level would be required to hold extra capital in proportion to that risk. A bank’s exposure to declines in the economic value of its capital due to changes in interest rates is a factor that banking agencies will consider in evaluating a bank’s capital adequacy. The rule does not codify an explicit minimum capital charge for interest rate risk. We currently monitor and manage our assets and liabilities for interest rate risk, and management believes that the interest rate risk rules which have been implemented and proposed will not materially adversely affect our operations.

The FRB’s “leverage” ratio rules require member banks which are rated the highest in the composite areas of capital, asset quality, management, earnings and liquidity to maintain a ratio of Tier 1 capital to “adjusted total assets” of not less than 3.0%. For banks which are not the most highly rated, the minimum “leverage” ratio will range from 4.0% to 5.0%, or higher at the discretion of the FRB, and is required to be at a level commensurate with the nature of the level of risk of a bank’s condition and activities.

For purposes of the capital requirements, “Tier 1” or “core” capital is defined to include common shareholders’ equity and certain noncumulative perpetual preferred stock and related surplus. “Tier 2” or “qualifying supplementary” capital is defined to include a bank’s allowance for loan and lease losses up to 1.25% of risk-weighted assets, plus certain types of preferred stock and related surplus, certain “hybrid capital instruments” and certain term subordinated debt instruments.

NEW CAPITAL RULE – BASEL III

On July 9, 2013, the federal bank regulatory agencies issued a final rule that revised their risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision (“Basel III”) and certain provisions of the Dodd-Frank Act. The final rule applies to all depository institutions, top-tier bank holding companies with total consolidated assets of $500 million or more and top-tier savings and loan holding companies.

The rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4.0% to 6.0% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property.

The rule also includes changes in what constitutes regulatory capital, some of which are subject to a two-year transition period. These changes include the phasing-out of certain instruments as qualifying capital. In addition, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock will be required to be deducted from capital, subject to a two-year transition period. Finally, Tier 1 capital will include accumulated other comprehensive income (which includes all unrealized gains and losses on available for sale debt and equity securities), subject to a two-year transition period.

The new capital requirements also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital; and increased risk-weights (from 0% to up to 600%) for equity exposures.

Finally, the rule limits capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements.

The final rule becomes effective on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019.

It is management’s belief that, as of December 31, 2013, we would meet all capital adequacy requirements under the new capital rules on a fully phased-in basis if such requirements were currently effective.

PROMPT CORRECTIVE ACTION RULES

The federal banking agencies have regulations defining the levels at which an insured institution would be considered “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “criticall undercapitalized.” Institutions that are classified as undercapitalized, significantly undercapitalized or critically undercapitalized are subject to various supervision measures based on the degree of undercapitalization. The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a “well-capitalized” institution as “adequately capitalized” or require an “adequately capitalized” or “undercapitalized” institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). The Bank satisfies the criteria to be classified as “well capitalized” within the meaning of applicable regulations.

REGULATORY RESTRICTIONS ON BANK DIVIDENDS

The Bank may not declare a dividend without approval of the FRB, 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 years, less any required transfers to surplus.

Under Pennsylvania law, the Bank may only declare and pay dividends from its accumulated net earnings. In addition, the Bank may not declare and pay dividends from the surplus funds that Pennsylvania law requires that it maintain. Under these policies and subject to the restrictions applicable to the Bank, the Bank could have declared, during 2013, without prior regulatory approval, aggregate dividends of approximately $19.2 million, plus net profits earned to the date of such dividend declaration.

BANK SECRECY ACT

Under the Bank Secrecy Act (BSA), banks and other financial institutions are required to retain records to assure that the details of financial transactions can be traced if investigators need to do so. Banks are also required to report most cash transactions in amounts exceeding $10,000 made by or on behalf of their customers. Failure to meet BSA requirements may expose the Bank to statutory penalties, and a negative compliance record may affect the willingness of regulating authorities to approve certain actions by the Bank requiring regulatory approval, including new branches.

INSURANCE OF DEPOSIT ACCOUNTS

The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC. Under the FDIC's risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned, and certain adjustments specified by FDIC regulations. Until recently, assessment rates ranged from seven to 77.5 basis points of assessable deposits.

On February 7, 2011, as required by the Dodd-Frank Act, the FDIC issued final rules implementing changes to the assessment rules. The rule, which took effect April 1, 2011, changes the assessment base used for calculating deposit insurance assessments from deposits to total assets less tangible (Tier 1) capital. Since the new base is larger than the previous base, the FDIC also lowered assessment rates so that the rule would not significantly alter the total amount of revenue collected from the industry. The range of adjusted assessment rates is now 2.5 to 45 basis points of the new assessment base. The rule is expected to benefit smaller financial institutions, which typically rely more on deposits for funding, and shift more of the burden for supporting the insurance fund to larger institutions, which are thought to have greater access to nondeposit funding.

The FDIC imposed on all insured institutions a special emergency assessment of five basis points of total assets minus Tier 1 capital (as of June 30, 2009), capped at ten basis points of an institution's deposit assessment base, in order to cover losses to the DIF. That special assessment was collected on September 30, 2009. In lieu of further special assessments, however, the FDIC required insured institutions to prepay estimated quarterly risk-based assessments for the fourth quarter of 2009 through the fourth quarter of 2012. That prepayment, which included an assumed annual assessment base increase of 5%, was recorded as a prepaid expense asset as of December 30, 2009. As of December 31, 2009, and each quarter through June of 2013, a charge to earnings was recorded for each regular assessment with an offsetting credit to the prepaid asset, after which the remaining prepaid asset was repaid by the FDIC and a quarterly assessment was charged on an accrual basis.

Due to the recent difficult economic conditions, deposit insurance per account owner has been raised to $250,000 for all types of accounts. That coverage was made permanent by the Dodd-Frank Act

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. That payment is established quarterly and during the four quarters ended December 31, 2011 averaged 0.925 basis points of assessable deposits.

The Dodd-Frank Act increased the minimum target DIF ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The FDIC must seek to achieve the 1.35% ratio by September 30, 2020. Insured institutions with assets of $10 billion or more are supposed to fund the increase. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the FDIC. The FDIC has recently exercised that discretion by establishing a long range fund ratio of 2%.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or regulatory condition imposed in writing. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

FEDERAL RESERVE SYSTEM

Under FRB regulations, the Bank is required to maintain reserves against its transaction accounts (primarily NOW and regular checking accounts). Beginning January 23, 2014, the Bank is required to maintain average daily reserves equal to 3% on aggregate transaction accounts of up to $89.0 million, plus 10% on the remainder, and the first $13.3 million of otherwise reservable balances will be exempt. These reserve requirements are subject to adjustment by the FRB. The Bank is in compliance with the foregoing requirements.

ACQUISITION OF THE HOLDING COMPANY

Under the Federal Change in Bank Control Act (the "CIBCA"), a notice must be submitted to the FRB if any person (including a company), or group acting in concert, seeks to acquire 10% or more of the Company's shares of outstanding common stock, unless the FRB has found that the acquisition will not result in a change in control of the Company. Under the CIBCA, the FRB generally has 60 days within which to act on such notices, taking into consideration certain factors, including the financial and managerial resources of the acquirer, the convenience and needs of the communities served by the Company and the Bank, and the anti-trust effects of the acquisition. Under the BHCA, any company would be required to obtain prior approval from the FRB before it may obtain "control" of the Company within the meaning of the BHCA. Control generally is defined to mean the ownership or power to vote 25% or more of any class of voting securities of the Company or the ability to control in any manner the election of a majority of the Company's directors. An existing bank holding company would be required to obtain the FRB's prior approval under the BHCA before acquiring more than 5% of the Company's voting stock.

HOLDING COMPANY REGULATION

The Company, as a bank holding company, is subject to examination, supervision, regulation, and periodic reporting under the Bank Holding Company Act of 1956, as amended, as administered by the FRB. The Company is required to obtain the prior approval of the FRB to acquire all, or substantially all, of the assets of any bank or bank holding company. Prior FRB approval would be required for the Company to acquire direct or indirect ownership or control of any voting securities of any bank or bank holding company if it would, directly or indirectly, own or control more than 5% of any class of voting shares of the bank or bank holding company.

A bank holding company is generally prohibited from engaging in, or acquiring, direct or indirect control of more than 5% of the voting securities of any company engaged in nonbanking activities. One of the principal exceptions to this prohibition is for activities found by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Some of the principal activities that the FRB has determined by regulation to be closely related to banking are: (i) making or servicing loans; (ii) performing certain data processing services; (iii) providing securities brokerage services; (iv) acting as fiduciary, investment or financial advisor; (v) leasing personal or real property under certain conditions; (vi) making investments in corporations or projects designed primarily to promote community welfare; and (vii) acquiring a savings association.

A bank holding company that meets specified conditions, including that its depository institutions subsidiaries are "well capitalized" and "well managed," can opt to become a "financial holding company." A "financial holding company" may engage in a broader array of financial activities than permitted a typical bank holding company. Such activities can include insurance underwriting and investment banking. The Company does not anticipate opting for "financial holding company" status at this time.

The Company is subject to the FRB's consolidated capital adequacy guidelines for bank holding companies. Traditionally, those guidelines have been structured similarly to the regulatory capital requirements for the subsidiary depository institutions, but were somewhat more lenient. For example, the holding company capital requirements allowed inclusion of certain instruments in Tier 1 capital that are not includable at the institution level. As previously noted, the Dodd-Frank Act requires that the guidelines be amended so that they are at least as stringent as those required for the subsidiary depository institutions. See "—The Dodd-Frank Act."

A bank holding company is generally required to give the FRB prior written notice of any purchase or redemption of then outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the Company's consolidated net worth. The FRB may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe and unsound practice, or would violate any law, regulation, FRB order or directive, or any condition imposed by, or written agreement with, the FRB. The FRB has adopted an exception to that approval requirement for well-capitalized bank holding companies that meet certain other conditions.

The FRB has issued a policy statement regarding the payment of dividends by bank holding companies. In general, the FRB's policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the bank holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. The FRB's policies also require that a bank holding company serve as a source of financial strength to its subsidiary banks by using available resources to provide capital funds during periods of financial stress or adversity and by maintaining the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks where necessary. The Dodd-Frank Act codified the source of strength policy and requires the promulgation of implementing regulations. Under the prompt corrective action laws, the ability of a bank holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. These regulatory policies could affect the ability of the Company to pay dividends or otherwise engage in capital distributions.

The Federal Deposit Insurance Act makes depository institutions liable to the Federal Deposit Insurance Corporation for losses suffered or anticipated by the insurance fund in connection with the default of a commonly controlled depository institution or any assistance provided by the Federal Deposit Insurance Corporation to such an institution in danger of default. That law would have potential applicability if the Company ever held as a separate subsidiary a depository institution in addition to the Bank.

The status of the Company as a registered bank holding company under the Bank Holding Company Act will not exempt it from certain federal and state laws and regulations applicable to corporations generally, including, without limitation, certain provisions of the federal securities laws.

EFFECT OF GOVERNMENT MONETARY POLICIES

The earnings and growth of the banking industry are affected by the credit policies of monetary authorities, including the Federal Reserve System. An important function of the Federal Reserve System is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open market activities in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These operations are used in varying combinations to influence overall economic growth and indirectly, bank loans, securities, and deposits. These variables may also affect interest rates charged on loans or paid on deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future.

In view of the changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities including the Federal Reserve System, no prediction can be made as to possible changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and the Bank. Additional information is included under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing in this Annual Report on Form 10-K.

ITEM 1A – RISK FACTORS.

Changing interest rates may decrease our earnings and asset values.

Our net interest income is the interest we earn on loans and investments less the interest we pay on our deposits and borrowings. Our net interest margin is the difference between the yield we earn on our assets and the interest rate we pay for deposits and our other sources of funding. Changes in interest rates—up or down—could adversely affect our net interest margin and, as a result, our net interest income. Although the yield we earn on our assets and our funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, causing our net interest margin to expand or contract. Our liabilities tend to be shorter in duration than our assets, so they may adjust faster in response to changes in interest rates. As a result, when interest rates rise, our funding costs may rise faster than the yield we earn on our assets, causing our net interest margin to contract until the asset yields catch up. Changes in the slope of the "yield curve"—or the spread between short-term and long-term interest rates—could also reduce our net interest margin. Normally, the yield curve is upward sloping, meaning short-term rates are lower than long-term rates. Because our liabilities tend to be shorter in duration than our assets, when the yield curve flattens or even inverts, we could experience pressure on our net interest margin as our cost of funds increases relative to the yield we can earn on our assets.

Changes in interest rates also affect the value of the Bank's interest-earning assets, and in particular the Bank's securities portfolio. Generally, the value of fixed-rate securities fluctuates inversely with changes in interest rates. Unrealized gains and losses on securities available for sale are reported as a separate component of shareholder equity, net of tax. Decreases in the fair value of securities available for sale resulting from increases in interest rates could have an adverse effect on shareholders' equity.

Local economic conditions are being increasingly impacted by the exploration of the Marcellus Shale natural gas exploration and drilling activities.

The economy in a large portion of our market areas has become increasingly influenced by the natural gas industry. 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. Additionally, many of our customers provide transportation and other services and products that support natural gas exploration and production activities. Moreover, we have experienced an increase in deposits as a result of this natural resource exploration and have developed products specifically targeting those that have benefited from this activity. 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. In addition, these activities can be affected by the market price for natural gas. These factors could negatively impact our customers and, as a result, negatively impact our loan and deposit volume. If there is a significant downturn in this industry, as a result of regulatory action or otherwise, the ability of our borrowers to repay their loans in accordance with their terms could be negatively impacted and/or reduce demand for loans. Finally, the borrowing needs of some of the residents in our market area have been limited due to the economic benefits afforded them as a result of the Marcellus Shale. These factors could have a material adverse effect on our business, prospects, financial condition and results of operations.

Higher loan losses could require us to increase our allowance for loan losses through a charge to earnings.

When we loan money we incur the risk that our borrowers do not repay their loans. We reserve for loan losses by establishing an allowance through a charge to earnings. The amount of this allowance is based on our assessment of loan losses inherent in our loan portfolio. The process for determining the amount of the allowance is critical to our financial results and condition. It requires subjective and complex judgments about the future, including forecasts of economic or market conditions that might impair the ability of our borrowers to repay their loans. We might underestimate the loan losses inherent in our loan portfolio and have loan losses in excess of the amount reserved. We might increase the allowance because of changing economic conditions. For example, in a rising interest rate environment, borrowers with adjustable-rate loans could see their payments increase. There may be a significant increase in the number of borrowers who are unable or unwilling to repay their loans, resulting in our charging off more loans and increasing our allowance. In addition, when real estate values decline, the potential severity of loss on a real estate-secured loan can increase significantly, especially in the case of loans with high combined loan-to-value ratios. A decline in the national economy and the local economies of the areas in which the loans are concentrated could result in an increase in loan delinquencies, foreclosures or repossessions resulting in increased charge-off amounts and the need for additional loan loss allowances in future periods. In addition, bank regulators may require us to make a provision for loan losses or otherwise recognize further loan charge-offs following their periodic review of our loan portfolio, our underwriting procedures, and our loan loss allowance. Any increase in our allowance for loan losses or loan charge-offs as required by such regulatory authorities could have a material adverse effect on our financial condition and results of operations. Our allowance for loan losses amounted to $7.1 million, or 1.31% of total loans outstanding and 80.7% of nonperforming loans, at December 31, 2013. Our allowance for loan losses at December 31, 2013 may not be sufficient to cover future loan losses. A large loss could deplete the allowance and require increased provisions to replenish the allowance, which would decrease our earnings. In addition, at December 31, 2013, we had a total of 20 loan relationships with outstanding balances that exceeded

$3.0 million, 19 of which were performing according to their original terms. However, the deterioration of one or more of these loans could result in a significant increase in our nonperforming loans and our provision for loan losses, which would negatively impact our results of operations.

Our emphasis on commercial real estate, agricultural, construction and municipal lending may expose us to increased lending risks.

At December 31, 2013, we had $193.1 million in loans secured by commercial real estate, $22.0 million in agricultural loans, $8.9 million in construction loans and $65.9 million in municipal loans. Commercial real estate loans, agricultural, construction and municipal loans represented 35.7%, 4.1%, 1.7% and 12.2%, respectively, of our loan portfolio. At December 31, 2013, we had $4.9 million of reserves specifically allocated to these loan types. While commercial real estate, agricultural, construction and municipal loans are generally more interest rate sensitive and carry higher yields than do residential mortgage loans, these types of loans generally expose a lender to greater risk of non-payment and loss than single-family residential mortgage loans because repayment of the loans often depends on the successful operation of the property, the income stream of the borrowers and, for construction loans, the accuracy of the estimate of the property's value at completion of construction and the estimated cost of construction. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to single-family residential mortgage loans.

If we conclude that the decline in value of any of our investment securities is other than temporary, we are required to write down the value of that security through a charge to earnings.

We review our investment securities portfolio monthly and at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of our investment securities has declined below its carrying value, we are required to assess whether the decline is other than temporary. If we conclude that the decline is other than temporary, we are required to write down the value of that security through a charge to earnings. As of December 31, 2013, our investment portfolio included available for sale investment securities with an amortized cost of $317.5 million and a fair value of $317.3 million, which included unrealized losses on 98 securities totaling $4.7 million. Changes in the expected cash flows of these securities and/or prolonged price declines may result in our concluding in future periods that the impairment of these securities is other than temporary, which would require a charge to earnings to write down theses securities to their fair value. Any charges for other-than-temporary impairment would not impact cash flow, tangible capital or liquidity.

Income from secondary mortgage market operations is volatile, and we may incur losses or charges with respect to our secondary mortgage market operations which would negatively affect our earnings.

We generally sell in the secondary market the longer term fixed-rate residential mortgage loans that we originate, earning non-interest income in the form of gains on sale. When interest rates rise, the demand for mortgage loans tends to fall and may reduce the number of loans available for sale. In addition to interest rate levels, weak or deteriorating economic conditions also tend to reduce loan demand. Although we sell loans in the secondary market without recourse, we are required to give customary representations and warranties to the buyers. If we breach those representations and warranties, the buyers can require us to repurchase the loans and we may incur a loss on the repurchase. Because we generally retain the servicing rights on the loans we sell in the secondary market, we are required to record a mortgage servicing right asset, which we test annually for impairment. The value of mortgage servicing rights tends to increase with rising interest rates and to decrease with falling interest rates. If we are required to take an impairment charge on our mortgage servicing rights our earnings would be adversely affected.

The Company's financial condition and results of operations are dependent on the economy in the Bank's market area.

The Bank's primary market area consists of the Pennsylvania Counties of Bradford, Potter, and Tioga in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga Counties in Southern New York. As of December 31, 2013, management estimates that approximately 92.8% of deposits and 78.2% of loans came from households whose primary address is located in the Bank's primary market area. Because of the Bank's concentration of business activities in its market area, the Company's financial condition and results of operations depend upon economic conditions in its market area. Adverse economic conditions in our market area could reduce our growth rate, affect the ability of our customers to repay their loans and generally affect our financial condition and results of operations. Conditions such as inflation, recession, unemployment, high interest rates and short money supply and other factors beyond our control may adversely affect our profitability. We are less able than a larger institution to spread the risks of unfavorable local economic conditions across a large number of diversified economies. Any sustained period of increased payment delinquencies, foreclosures or losses caused by adverse market or economic conditions in the States of Pennsylvania and New York could adversely affect the value of our assets, revenues, results of operations and financial condition. Moreover, we cannot give any assurance we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

A return of recessionary conditions could result in increases in our level of nonperforming loans and/or reduce demand for our products and services, which could have an adverse effect on our results of operations.

Although the U.S. economy has emerged from the severe recession that occurred in 2008 and 2009, economic growth has been slow and uneven, and unemployment levels remain high. Recovery by many businesses has been impaired by lower consumer spending. A return to prolonged deteriorating economic conditions and/or continued negative developments in the domestic and international credit markets could significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. These events may cause us to incur losses and may adversely affect our financial condition and results of operations.

Regulation of the financial services industry is undergoing major changes, and future legislation could increaseour cost of doing business or harm our competitive position.

We are subject to extensive regulation, supervision and examination by the FRB and the PDB, our primary regulators, and by the FDIC, as insurer of our deposits. Such regulation and supervision governs the activities in which an institution and its holding company may engage and are intended primarily for the protection of the insurance fund and the depositors and borrowers of the Bank rather than for holders of our common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

In 2010 and 2011, in response to the financial crisis and recession that began in 2008, significant regulatory and legislative changes resulted in broad reform and increased regulation impacting financial institutions. The Dodd-Frank Act has created a significant shift in the way financial institutions operate. The Dodd-Frank Act also created the Consumer Financial Protection Bureau to administer consumer protection and fair lending laws, a function that was formerly performed by the depository institution regulators. The Dodd-Frank Act contains various other provisions designed to enhance the regulation of depository institutions and prevent the recurrence of a financial crisis such as occurred in 2008-2009. The full impact of the Dodd-Frank Act on our business and operations will not be known for years until all the regulations fully implementing the statute are written and adopted. The Dodd-Frank Act may have a material impact on our operations, particularly through increased regulatory burden and compliance costs. Any further legislative changes could have a material impact on our profitability. Future legislative changes could require changes to business practices or force us to discontinue businesses and potentially expose us to additional costs, liabilities, enforcement action and reputational risk.

Additionally, in early July 2013, the FRB approved revisions to their capital adequacy guidelines and prompt corrective action rules that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. Basel III and the regulations of the federal banking agencies require bank holding companies and banks to undertake significant activities to demonstrate compliance with the new and higher capital standards. Compliance with these rules will impose additional costs on us.

We are periodically subject to examination and scrutiny by a number of banking agencies and, depending upon the findings and determinations of these agencies, we may be required to make adjustments to our business that could adversely affect us.

Federal and state banking agencies periodically conduct examinations of our business, including compliance with applicable laws and regulations. If, as a result of an examination, a banking agency was to determine that the financial condition, capital resources, asset quality, asset concentration, earnings prospects, management, liquidity, sensitivity to market risk or other aspects of any of our operations has become unsatisfactory, or that we or our management is in violation of any law or regulation, it could take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin “unsafe or unsound” practices, to require affirmative actions to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to change the asset composition of our portfolio or balance sheet, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance. If we become subject to such regulatory actions, our business, results of operations and reputation may be negatively impacted.

Strong competition within the Bank's market area could hurt profits and slow growth.

The Bank faces intense competition both in making loans and attracting deposits. This competition has made it more difficult for the Bank to make new loans and at times has forced the Bank to offer higher deposit rates. Price competition for loans and deposits might result in the Bank earning less on loans and paying more on deposits, which would reduce net interest income. Competition also makes it more difficult to increase loans and deposits. As of June 30, 2013, which is the most recent date for which information is available, for those counties in which the Bank has branches, we held 35.1% of the deposits in Bradford, Potter and Tioga Counties, Pennsylvania, which was the largest share of deposits out of eight financial institutions with offices in the area, and 6.3% of the deposits in Allegany County, New York, which was the fourth largest share of deposits out of five financial institutions with offices in this area. Competition also makes it more difficult to hire and retain experienced employees. Some of the institutions with which the Bank competes have substantially greater resources and lending limits than the Bank has and may offer services that the Bank does not provide. Management expects competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. The Bank's profitability depends upon its continued ability to compete successfully in its market area.

We rely on our management and other key personnel, and the loss of any of them may adversely affect our operations.

We are and will continue to be dependent upon the services of our executive management team. In addition, we will continue to depend on our ability to retain and recruit key commercial loan officers. The unexpected loss of services of any key management personnel or commercial loan officers could have an adverse effect on our business and financial condition because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Environmental liability associated with lending activities could result in losses.

In the course of our business, we may foreclose on and take title to properties securing our loans. If hazardous substances were discovered on any of these properties, we could be liable to governmental entities or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination. In addition, if we arrange for the disposal of hazardous or toxic substances at another site, we may be liable for the costs of cleaning up and removing those substances from the site even if we neither own nor operate the disposal site. Environmental laws may require us to incur substantial expenses and may materially limit use of properties we acquire through foreclosure, reduce their value or limit our ability to sell them in the event of a default on the loans they secure. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability.

Our ability to pay dividends is limited by law.

Our ability to pay dividends to our shareholders largely depends on our receipt of dividends from the Bank. The amount of dividends that the Bank may pay to us is limited by federal and state laws and regulations. We also may decide to limit the payment of dividends even when we have the legal ability to pay them in order to retain earnings for use in our business.

Federal and state banking laws, our articles of incorporation and our by-laws may have an anti-takeover effect.

Federal law imposes restrictions, including regulatory approval requirements, on persons seeking to acquire control over us. Pennsylvania law also has provisions that may have an anti-takeover effect. These provisions may serve to entrench management or discourage a takeover attempt that shareholders consider to be in their best interest or in which they would receive a substantial premium over the current market price.

We are subject to certain risks in connection with our use of technology

Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger, our deposits, and our loans. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious code and cyber attacks that could have a security impact.

In addition, breaches of security may occur through intentional or unintentional acts by those having authorized or unauthorized access to our confidential or other information or the confidential or other information of our customers, clients, or counterparties. If one or more of such events were to occur, the confidential and other information processed and stored in, and transmitted through, our computer systems and networks could potentially be jeopardized, or could otherwise cause interruptions or malfunctions in our operations or the operations of our customers, clients, or counterparties. This could cause us significant reputational damage or result in our experiencing significant losses.

Furthermore, we may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures arising from operational and security risks. Also, we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance we maintain.

In addition, we routinely transmit and receive personal, confidential, and proprietary information by e-mail and other electronic means. We have discussed and worked with our customers, clients, and counterparties to develop secure transmission capabilities, but we do not have, and may be unable to put in place, secure capabilities with all of these constituents, and we may not be able to ensure that these third parties have appropriate controls in place to protect the confidentiality of such information. Any interception, misuse, or mishandling of personal, confidential, or proprietary information being sent to or received from a customer, client, or counterparty could result in legal liability, regulatory action, and reputational harm, and could have a significant adverse effect on our competitive position, financial condition, and results of operations.

Our risk management framework may not be effective in mitigating risks and/or losses to us.

We have implemented a risk management framework to manage our risk exposure. This framework is comprised of various processes, systems and strategies, and is designed to manage the types of risk to which we are subject, including, among others, credit, market, liquidity, interest rate and compliance. Our framework also includes financial or other modeling methodologies which involve management assumptions and judgment. There is no assurance that our risk management framework will be effective under all circumstances or that it will adequately mitigate any risk or loss to us. If our framework is not effective, we could suffer unexpected losses and our business, financial condition, results of operations or prospects could be materially and adversely affected. We may also be subject to potentially adverse regulatory consequences.

ITEM 1B – UNRESOLVED STAFF COMMENTS.

Not applicable.

ITEM 2 – PROPERTIES.

The headquarters of the Company and Bank are located at 15 South Main Street, Mansfield, Pennsylvania. The building contains the central offices of the Company and Bank. Our bank owns fourteen banking facilities, leases five other facilities and owns an additional vacant property for a possible future branch expansion. All buildings owned by the Bank are free of any liens or encumbrances.

The net book value of owned banking facilities and leasehold improvements totaled $10,395,000 as of December 31, 2013. The properties are adequate to meet the needs of the employees and customers. We have equipped all of our facilities with current technological improvements for data processing.

ITEM 3 - LEGAL PROCEEDINGS.

The Company is not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Such routine legal proceedings in the aggregate are believed by management to be immaterial to the Company's financial condition or results of operations.

ITEM 4 – MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5 - MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

The Company's stock is not listed on any stock exchange, but it is quoted on the OTC Bulletin Board under the trading symbol CZFS. Prices presented in the table below are bid prices between broker-dealers published by the OTC Bulletin Board and the Pink Sheets Electronic Quotation Service. The prices do not include retail markups or markdowns or any commission to the broker-dealer. The bid prices do not necessarily reflect prices in actual transactions. Cash dividends are declared on a quarterly basis and are summarized in the table below (also see dividend restrictions in Note 14 of the consolidated financial statements).

	2013		Dividends declared	2012		Dividends declared
	High	Low	per share	High	Low	per share
First quarter	$ 47.62	$ 40.05	$ 0.272	$ 36.39	$ 33.42	$ 0.279
Second quarter	49.53	45.91	0.281	41.09	35.64	0.284
Third quarter	49.24	46.05	0.285	46.00	39.31	0.290
Fourth quarter	54.00	47.00	0.385	46.01	41.75	0.654

The Company has paid dividends since April 30, 1984, the effective date of our formation as a bank holding company. The Company's Board of Directors expects that comparable cash dividends will continue to be paid by the Company in the future; however, future dividends necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors in existence at the time the Board of Directors considers a dividend policy. Cash available for dividend distributions to stockholders of the Company comes primarily from dividends paid to the Company by the Bank. Therefore, restrictions on the ability of the Bank to make dividend payments are directly applicable to the Company. Under the Pennsylvania Business Corporation Law of 1988, the Company may pay dividends only if, after payment, the Company would be able to pay debts as they become due in the usual course of our business and total assets will be greater than the sum of total liabilities. These regulatory policies could affect the ability of the Company to pay dividends or otherwise engage in capital distributions. Also see "Supervision and Regulation – Regulatory Restrictions on Bank Dividends," "Supervision and Regulation – Holding Company Regulation," and "Note 14 – Regulatory Matter" to the consolidated financial statements.

The Company distributed a 5% stock dividend on June 28, 2013 to all shareholders of record as of June 21, 2013. All per share calculations were adjusted to reflect the stock dividend.

As of February 21, 2014, the Company had approximately 1,558 stockholders of record. The computation of stockholders of record excludes investors whose shares were held for them by a bank or broker at that date. The following table presents information regarding the Company's stock repurchases during the three months ended December 31, 2013:

Period	Total Number of Shares (or units Purchased)	Average Price Paid per Share (or	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)

		Unit)		that May Yet Be Purchased Under the Plans or Programs (1)
10/1/13 to 10/31/13	-	-	-	92,780
11/1/13 to 11/31/13	4,031	$47.19	4,031	88,749
12/1/13 to 12/31/13	274	$48.65	274	88,475
Total	4,305	$47.29	4,305	88,475

(1) On January 17, 2012, the Company announced that the Board of Directors authorized the Company to repurchase up to 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.

Set forth below is a line graph comparing the yearly dollar changes in the cumulative shareholder return on the Company's common stock against the cumulative total return of the S&P 500 Stock index, NASDAQ Bank Index, and SNL Mid-Atlantic Bank Index for the period of six fiscal years assuming the investment of $100.00 on December 31, 2007 and assuming the reinvestment of dividends. The shareholder return shown on the graph below is not necessarily indicative of future performance and was obtained from SNL Financial LC, Charlottesville, VA.

	Period Ending						
Index	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13
Citizens Financial Services, Inc.	$ 100.00	$ 103.26	$ 144.43	$ 217.74	$ 211.55	$ 276.86	$ 374.26
S&P 500	100.00	63.00	79.68	91.68	93.61	108.59	143.77
SNL Bank NASDAQ	100.00	72.62	58.91	69.51	61.67	73.51	105.65
SNL Mid-Atlantic Bank	100.00	55.09	57.99	67.65	50.82	68.08	91.77
SNL Bank $500M-$1B	100.00	64.08	61.03	66.62	58.61	75.14	97.43

16

ITEM 6 - SELECTED FINANCIAL DATA.

The following table sets forth certain financial data as of and for each of the years in the five year period ended December 31, 2013:

(in thousands, except share data)	2013	2012	2011	2010	2009
Interest income	$ 36,234	$ 38,085	$ 38,293	$ 39,000	$ 38,615
Interest expense	6,315	7,659	9,683	11,340	13,231
Net interest income	29,919	30,426	28,610	27,660	25,384
Provision for loan losses	405	420	675	1,255	925
Net interest income after provision for loan losses	29,514	30,006	27,935	26,405	24,459
Non-interest income	6,828	7,233	6,582	6,197	5,959
Investment securities gains, net	441	604	334	99	139
Non-interest expenses	19,656	19,297	18,409	18,043	18,010
Income before provision for income taxes	17,127	18,546	16,442	14,658	12,547
Provision for income taxes	3,752	4,331	3,610	3,156	2,683
Net income	$ 13,375	$ 14,215	$ 12,832	$ 11,502	$ 9,864
Per share data:					
Net income - Basic (1)	$ 4.42	$ 4.65	$ 4.16	$ 3.71	$ 3.18
Net income - Diluted (1)	4.42	4.65	4.16	3.71	3.18
Cash dividends declared (1)	1.22	1.51	1.09	1.02	0.95
Stock dividend	5%	1%	1%	1%	1%
Book value (1) (2)	30.94	27.89	24.88	21.86	19.18
End of Period Balances:					
Total assets	$ 914,934	$ 882,427	$ 878,567	$ 812,526	$ 729,477
Total investments	317,301	310,252	318,823	251,303	198,582
Loans	540,612	502,463	487,509	473,517	456,384
Allowance for loan losses	7,098	6,784	6,487	5,915	4,888
Total deposits	748,316	737,096	733,993	680,711	605,559
Total borrowings	66,932	46,126	53,882	55,996	54,115
Stockholders' equity	92,056	89,475	81,468	68,690	61,527
Key Ratios					
Return on assets (net income to average total assets)	1.51%	1.62%	1.52%	1.50%	1.42%
Return on equity (net income to average total equity)	14.89%	17.48%	17.86%	18.13%	17.65%
Equity to asset ratio (average equity to average					

total assets, excluding other comprehensive income)	10.13%	9.26%	8.49%	8.25%	8.02%
Net interest margin	3.87%	3.99%	3.94%	4.19%	4.23%
Efficiency	48.12%	46.10%	46.23%	47.96%	51.91%
Dividend payout ratio (dividends declared divided by net income)	27.63%	32.37%	26.30%	27.50%	29.92%
Tier 1 leverage	10.42%	9.70%	8.83%	8.32%	8.15%
Tier 1 risk-based capital	16.44%	16.21%	14.94%	13.72%	12.69%
Total risk-based capital	17.75%	17.50%	16.23%	14.97%	13.77%
Nonperforming assets/total loans	1.88%	1.83%	2.11%	2.80%	1.55%
Nonperforming loans/total loans	1.63%	1.71%	1.94%	2.65%	1.48%
Allowance for loan losses/total loans	1.31%	1.35%	1.33%	1.25%	1.07%
Net charge-offs/average loans	0.02%	0.02%	0.02%	0.05%	0.09%

(1) Amounts were adjusted to reflect stock dividends.
(2) Calculation excludes accumulated other comprehensive income.

ITEM 7 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

CAUTIONARY STATEMENT

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 the Company, the Bank, First Citizens Insurance Agency, Inc. or the Company on a consolidated basis. When we use words such as "believes," "expects," "anticipates," or similar expressions, we are making forward-looking statements. Forward-looking statements may prove inaccurate. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements:

- Interest rates could change more rapidly or more significantly than we expect.
- The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
- The financial markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.
- It could take us longer than we anticipate implementing strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.
- Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.
- We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition or operating results.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices or requirements.
- We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition. We could also experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.
- 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 are discussed in this Annual Report on Form 10-K under "Item 1A. Risk Factors." These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Forward-looking statements speak only as of the date they are made and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date of the forward-looking statements or to reflect the occurrence of unanticipated events. Accordingly, past results and trends should not be used by investors to anticipate future results or trends.

INTRODUCTION

The following is management's discussion and analysis of the significant changes in financial condition, the results of operations, capital resources and liquidity presented in its 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 audited consolidated financial statements and related notes. Except as noted, tabular information is presented in thousands of dollars.

Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung, and Tioga counties in Southern New York. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 20 banking facilities, 17 of which operate as bank branches. In Pennsylvania, these offices are 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. In New York, our office is in Wellsville. We also have two loan production offices in Lock Haven and Dallas, Pennsylvania. We have recently filed a branch application to convert the loan production office in Lock Haven to a full service branch.

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

Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the direction and frequency of changes in interest rates. Interest rate risk results from various re-pricing frequencies and the maturity structure of the financial instruments owned by the Company. The Company uses its asset/liability and funds management policies 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, which could include identify theft, or theft of customer information through third parties. We expend significant resources to comply with regulatory requirements. Failure to comply could result in reputational harm or significant legal or remedial costs. Damage to our reputation could adversely affect our ability to retain and attract new customers, and adversely impact our earnings and liquidity.

Regulatory risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company and its subsidiary. We cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations. We cannot anticipate additional requirements or additional compliance efforts regarding the Bank Secrecy Act, Dodd-Frank Act or USA Patriot Act, or regulatory burdens regarding the ever increasing information theft and fraudulent activities impacting our customers and the banking industry in general.

Readers should carefully review the risk factors described in other documents our Company files with the SEC, including the annual reports on Form 10-K, the quarterly reports on Form 10-Q and any current reports on Form 8-K filed by us.

TRUST AND INVESTMENT SERVICES; OIL AND GAS SERVICES

Our Investment and Trust Division is committed to helping our customers meet their financial goals. The Trust Division offers professional trust administration, investment management services, estate planning and administration, custody of securities and individual retirement accounts. Assets held by the Bank in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Bank. As of December 31, 2013 and 2012, assets owned and invested by customers of the Bank through the Bank's investment representatives totaled $102.5 million and $92.0 million, respectively. Additionally, as summarized in the table below, the Trust Department had assets under management as of December 31, 2013 and 2012 of $99.4 million and $105.6 million, respectively. The decrease in assets under management is due to net account withdrawals of $14.3 million offset by market valuation increases of $8.1 million.

(market values - in thousands)		2013		2012
INVESTMENTS:				
Bonds	$	15,729	$	18,848
Stock		16,893		23,811
Savings and Money Market Funds		13,959		15,521
Mutual Funds		51,591		46,106
Mortgages		562		558
Real Estate		645		670
Miscellaneous		56		40
TOTAL	$	99,435	$	105,554
ACCOUNTS:				
Trusts	$	20,866	$	27,313
Guardianships		226		982
Employee Benefits		39,819		37,588
Investment Management		38,510		39,647
Custodial		14		24
TOTAL	$	99,435	$	105,554

Our financial consultants offer full service brokerage services throughout the Bank's market area. Appointments can be made at any Bank branch. The financial consultants provide financial planning which includes mutual funds, annuities, health and life insurance. These products are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc.

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. We have partnered with a professional firm to provide additional expertise and services to customers in our market who have been impacted by the Marcellus Shale exploration and drilling activities. As of December 31, 2013, customers owning 8,365 acres have signed agreements with the Bank that provide for the Bank to manage oil and gas matters related to the customers land, which may include negotiating lease payments and royalty percentages, resolving leasing issues, accounting for and ensuring the accuracy of royalty checks, distributing revenue to satisfy investment objectives and providing customized reports outlining payment and distribution information.

RESULTS OF OPERATIONS

Net income for the twelve months ended December 31, 2013 was $13,375,000, which represents a decrease of $840,000, or 5.9%, when compared to the 2012 related period. Net income for the twelve months ended December 31, 2012 was $14,215,000, which represents an increase of $1,383,000, or 10.8%, when compared to the 2011 related period. Basic and diluted earnings per share were $4.42, $4.65, and $4.16 for the years ended 2013, 2012 and 2011, respectively.

Net income is influenced by five key components: net interest income, provision for loan losses, non-interest income, non-interest expenses, and the provision for income taxes.

Net Interest Income

The most significant source of revenue is net interest income; the amount of interest earned on interest-earning assets exceeding interest incurred on interest-bearing liabilities. Factors that influence net interest income are changes in volume of interest-earning assets and interest-bearing liabilities as well as changes in the associated interest rates.

The following table sets forth our Company's average balances of, and the interest earned or incurred on, each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and rate "spread" created:

Analysis of Average Balances and Interest Rates (1)

	2013			2012			2011		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%	$	$	%
ASSETS									
Short-term investments:									
Interest-bearing deposits at banks	15,024	25	0.17	14,439	21	0.15	30,508	81	0.27
Total short-term investments	15,024	25	0.17	14,439	21	0.15	30,508	81	0.27
Interest bearing time deposits at banks	743	15	2.02	-	-	-	-	-	-
Investment securities:									
Taxable	215,746	3,807	1.76	226,424	4,592	2.03	198,908	4,630	2.33
Tax-exempt (3)	92,911	5,159	5.55	94,221	5,608	5.95	90,794	5,555	6.12
Total investment securities	308,657	8,966	2.90	320,645	10,200	3.18	289,702	10,185	3.52
Loans:									
Residential mortgage loans	181,887	10,941	6.02	183,408	11,746	6.40	181,394	12,396	6.83
Construction loans	13,098	647	4.94	10,746	605	5.63	7,043	437	6.20
Commercial & agricultural loans	252,242	14,794	5.87	235,073	14,699	6.25	223,586	14,297	6.39
Loans to state & political subdivisions	59,759	2,647	4.43	57,247	2,680	4.68	52,113	2,709	5.20
Other loans	9,762	802	8.22	10,348	871	8.42	10,836	921	8.49
Loans, net of discount (2)(3)(4)	516,748	29,831	5.77	496,822	30,601	6.16	474,972	30,760	6.48
Total interest-earning assets	841,172	38,837	4.62	831,906	40,822	4.91	795,182	41,026	5.16
Cash and due from banks	3,750			3,736			9,996		
Bank premises and equipment	11,375			11,560			12,121		
Other assets	29,905			30,782			28,816		
Total non-interest earning assets	45,030			46,078			50,933		
Total assets	886,202			877,984			846,115		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									

NOW accounts	209,275	791	0.38	200,486	791	0.39	190,810	919	0.48
Savings accounts	92,095	146	0.16	84,558	165	0.20	71,205	195	0.27
Money market accounts	85,688	405	0.47	73,102	316	0.43	57,742	299	0.52
Certificates of deposit	271,862	3,765	1.38	290,710	4,841	1.67	312,284	6,531	2.09
Total interest-bearing deposits	658,920	5,107	0.78	648,856	6,113	0.94	632,041	7,944	1.26
Other borrowed funds	42,214	1,208	2.86	52,484	1,546	2.95	55,483	1,739	3.13
Total interest-bearing liabilities	701,134	6,315	0.90	701,340	7,659	1.09	687,524	9,683	1.41
Demand deposits	87,496			85,890			79,086		
Other liabilities	7,767			9,430			7,637		
Total non-interest-bearing liabilities	95,263			95,320			86,723		
Stockholders' equity	89,805			81,324			71,868		
Total liabilities & stockholders' equity	886,202			877,984			846,115		
Net interest income		32,522			33,163			31,343	
Net interest spread (5)			3.72%			3.82%			3.75%
Net interest income as a percentage of average interest-earning assets			3.87%			3.99%			3.94%
Ratio of interest-earning assets to interest-bearing liabilities			1.20			1.19			1.16

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

21

Tax exempt interest revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the 34% Federal statutory rate. Accordingly, tax equivalent adjustments for investments and loans have been made accordingly to the previous table for the years ended December 31, 2013, 2012 and 2011, respectively (in thousands):

	2013	2012	2011
Interest and dividend income from investment securities, interest bearing time deposits and short-term investments (non-tax adjusted)	$ 7,252	$ 8,315	$ 8,377
Tax equivalent adjustment	1,754	1,906	1,889
Interest and dividend income from investment securities, interest bearing time deposits and short-term investments (tax equivalent basis)	$ 9,006	$ 10,221	$ 10,266

	2013	2012	2011
Interest and fees on loans (non-tax adjusted)	$ 28,982	$ 29,770	$ 29,916
Tax equivalent adjustment	849	831	844
Interest and fees on loans (tax equivalent basis)	$ 29,831	$ 30,601	$ 30,760

	2013	2012	2011
Total interest income	$ 36,234	$ 38,085	$ 38,293
Total interest expense	6,315	7,659	9,683
Net interest income	29,919	30,426	28,610
Total tax equivalent adjustment	2,603	2,737	2,733
Net interest income (tax equivalent basis)	$ 32,522	$ 33,163	$ 31,343

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

Analysis of Changes in Net Interest Income on a Tax-Equivalent Basis

	2013 vs. 2012 (1)			2012 vs. 2011 (1)		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
Interest Income:						
Short-term investments:						
Interest-bearing deposits at banks	$ 1	$ 3	$ 4	$ (32)	$ (28)	$ (60)
Interest bearing time deposits at banks	15	-	15	-	-	-
Investment securities:						
Taxable	(209)	(576)	(785)	598	(636)	(38)
Tax-exempt	(77)	(372)	(449)	189	(136)	53
Total investment securities	(286)	(948)	(1,234)	787	(772)	15
Total investment income	(270)	(945)	(1,215)	755	(800)	(45)
Loans:						
Residential mortgage loans	(96)	(709)	(805)	140	(790)	(650)
Construction loans	96	(54)	42	204	(36)	168
Commercial & agricultural loans	630	(535)	95	706	(304)	402
Loans to state & political subdivisions	144	(177)	(33)	253	(282)	(29)
Other loans	(48)	(21)	(69)	(42)	(8)	(50)
Total loans, net of discount	726	(1,496)	(770)	1,261	(1,420)	(159)
Total Interest Income	456	(2,441)	(1,985)	2,016	(2,220)	(204)
Interest Expense:						
Interest-bearing deposits:						
NOW accounts	17	(17)	-	49	(177)	(128)
Savings accounts	18	(37)	(19)	55	(85)	(30)
Money Market accounts	57	32	89	45	(28)	17
Certificates of deposit	(299)	(777)	(1,076)	(428)	(1,262)	(1,690)

Total interest-bearing deposits	(207)	(799)	(1,006)	(279)	(1,552)	(1,831)
Other borrowed funds	(295)	(43)	(338)	(91)	(102)	(193)
Total interest expense	(502)	(842)	(1,344)	(370)	(1,654)	(2,024)
Net interest income	$ 958	$ (1,599)	$ (641)	$ 2,386	$ (566)	$ 1,820

(1) The portion of 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.

2013 vs. 2012

Tax equivalent net interest income for 2013 was $32,522,000 compared with $33,163,000 for 2012, a decrease of $641,000 or 1.9%. Total interest income decreased $1,985,000, as total investment income decreased $1,215,000 and loan interest income decreased $770,000. Offsetting the decrease in interest income, interest expense decreased $1,344,000 from 2012.

Total tax equivalent interest income from investment securities decreased $1,234,000 in 2013 from 2012. The average balance of investment securities decreased $12.0 million, which had an effect of decreasing interest income by $286,000 due to volume. The average tax-effected yield on our investment portfolio decreased from 3.18% in 2012 to 2.90% in 2013. This had the effect of decreasing interest income by $948,000 due to rate, the majority of which was related to taxable securities whose yield decreased from 2.03% in 2012 to 1.76% in 2013. During 2013, rates on the short end of the curve experienced very little change, while the long end of the curve experienced a rise in excess of 100 basis points. In addition, during the fourth quarter of 2013, the Federal Reserve reduced the amount of quantitative easing it was providing to the market and indicated that a further reduction could be expected, while at the same time committing to low short term rates. This has resulted in a relatively steep yield curve. As a result, the investment strategy as of the end of 2013 has been to purchase agency securities with maturities of less than five years and high quality municipal bonds with high coupons. Due to the steepness of the yield curve of maturities between two to five years, the Bank has provided itself some protection to rising rates, if they occur. Additionally, high coupon municipal bonds have less price volatility in rising rate scenarios than similar lower coupon bonds. We believe this strategy will enable us to reinvest cash flows in the next two to five years when and if investment opportunities improve.

In total, loan interest income decreased $770,000 in 2013 from 2012. The average balance of our loan portfolio increased by $19.9 million in 2013 compared to 2012, which resulted in an increase in interest income of $726,000 due to volume. Offsetting this was a decrease in average yield on total loans from 6.16% in 2012 to 5.77% in 2013 resulting in a decrease in interest income of $1,496,000 due to rate.

Specifically, interest income on residential mortgage loans decreased $805,000, $709,000 of which is attributable to rate as the average yield on residential mortgages decreased from 6.40% in 2012 to 6.02% in 2013. There was also a decrease due to volume of $96,000, as the average balance of residential mortgage loans decreased $1.5 million. Due to continued, low mortgage interest rates on conforming mortgages during 2013, the Company decided to sell most conforming mortgage loans originated by the Bank to minimize interest rate risk in rising rate environments. During 2013, conforming loans totaling $20,239,000 were originated and sold on the secondary market. Currently, all loans sold by the Bank are sold without recourse, with servicing retained.

The average balance of construction loans increased $2.4 million from 2012 to 2013, which had a positive impact of $96,000 on interest income. This was offset by a decrease due to a reduction in yield of $54,000 as the average yield on construction loans decreased from 5.63% in 2012 to 4.94% in 2013. The average balance of commercial and agricultural loans increased $17.2 million from 2012 to 2013 which had a positive impact of $630,000 on total interest income due to volume. We continue to focus on this segment of the loan portfolio, utilizing an experienced lending staff. Offsetting the increase due to volume, the average yield on commercial and agricultural loans decreased from 6.25% in 2012 to 5.87% in 2013, decreasing interest income by $535,000. The decreasing yield was the result of competitive pressures to obtain and retain quality credits in the current economic environment as well as the fact that existing loans are repricing in a lower rate environment. The average balance of loans to state and political subdivisions increased $2.5 million from 2013 to 2012 primarily as a result of municipalities in our area that continued to borrow funds to ensure compliance with U.S. Environmental Protection Agency laws and regulations impacting the Chesapeake Bay watershed. This had a positive impact of $144,000 on total interest income due to volume. Offsetting this, the average tax equivalent yield on loans to state and political subdivisions decreased from 4.68% in 2012 to 4.43% in 2013, decreasing interest income by $177,000. The decreasing yield was again largely due to competitive pressures to obtain and retain quality credits in the current economic environment.

Total interest expense decreased $1,344,000 in 2013 compared to 2012. The decrease is primarily attributable to a change in average rate from 1.09% in 2012 to .90% in 2013, which had the effect of decreasing interest expense by $842,000. The continued low interest rate environment prompted by the Federal Reserve 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. The average balance of interest bearing liabilities decreased $206,000 from 2012 to 2013. Certificates of deposit and other borrowed funds decreased $18.8 million and $10.3 million, respectively, which resulted in a decrease in interest expense due to volume of $502,000. These decreases were offset by increases in NOW accounts of $8.8 million, savings accounts of $7.5 million and money market accounts of $12.6 million. The cumulative effect of these increases was an increase in interest expense of $92,000.

The average balance of certificates of deposit decreased $18.8 million causing a decrease in interest expense of $299,000. In addition, as a result of the continued low rate environment, there was a decrease in the average rate on certificates of deposit from 1.67% to 1.38% resulting in a decrease in interest expense of $777,000. The average balance of other borrowed funds decreased $10.3 million causing a decrease in interest expense of $295,000. In addition, there was a decrease in the average rate on other borrowed funds from 2.95% to 2.86% resulting in a decrease in interest expense of $43,000.

Our net interest spread for 2013 was 3.72% compared to 3.82% in 2012. The current economic situation has resulted in a flattening of the short term portion of the yield curve, with the mid to long range portion of the curve being steeper. Should long-term interest rates move in such a way that results in a further flattened or inverted yield curve, we would anticipate additional pressure on our margin. Additionally, it should be noted that there is currently more downward pressure on the pricing of interest earning assets than there is on interest bearing liabilities due to the rates that are currently being offered.

2012 vs. 2011

Tax equivalent net interest income for 2012 was $33,163,000 compared with $31,343,000 for 2011, an increase of $1,820,000 or 5.8%. Total interest income decreased $204,000, as total investment income decreased $45,000 and loan interest income decreased $159,000. The largest driver of the increase in net interest income was interest expense, as it decreased $2,024,000 from 2011.

Total tax equivalent interest income from investment securities increased $15,000 in 2012 from 2011. The average balance of investment securities increased $30.9 million, which had an effect of increasing interest income by $787,000 due to volume. The average tax-effected yield on our investment portfolio decreased from 3.52% in 2011 to 3.18% in 2012. This had the effect of decreasing interest income by $772,000 due to rate, the majority of which was related to taxable securities whose yield decreased from 2.33% in 2011 to 2.03% in 2012. During 2012, the Company implemented a strategy to increase portfolio duration through the purchase of certain mortgage backed securities and longer term agencies to provide additional interest income. This strategy maintained a defensive posture to future rising rates by selecting securities that had limited extension risk. By increasing duration with defensive securities the Bank was able to increase interest income with minimal additional interest rate risk. As part of implementing this strategy, in the first quarter of 2012, the Company purchased certain investment securities utilizing overnight borrowings, which were repaid in the second quarter as other investment securities matured or were called.

In total, loan interest income decreased $159,000 in 2012 from 2011. The average balance of our loan portfolio increased by $21.9 million in 2012 compared to 2011, which resulted in an increase in interest income of $1,261,000 due to volume. Offsetting this was a decrease in average yield on total loans from 6.48% in 2011 to 6.16% in 2012 resulting in a decrease in interest income of $1,420,000 due to rate.

Interest income on residential mortgage loans decreased $650,000. The majority of the decrease is the result of a decrease of $790,000 attributable to rate as the average yield on residential mortgages decreased from 6.83% in 2011 to 6.40% in 2012. This was offset by an increase due to volume of $140,000, as the average balance of residential mortgage loans increased $2.0 million. During 2012, the Company decided to sell most conforming mortgage loans originated by the Bank to minimize interest rate risk in rising rate environments. During 2012, conforming loans totaling $37,398,000 were originated and sold due to the low residential mortgage rates offered during 2012.

The average balance of construction loans increased $3.7 million from 2011 to 2012, which had a positive impact of $204,000 on interest income. This was offset by a decrease due to a reduction in yield of $36,000 as the average yield on construction loans decreased from 6.2% in 2011 to 5.63% in 2012. The average balance of commercial and agricultural loans increased $11.5 million from 2011 to 2012 which had a positive impact of $706,000 on total interest income due to volume. Offsetting the increase, the average yield on commercial and agricultural loans decreased from 6.39% in 2011 to 6.25% in 2012, decreasing interest income by $304,000. The decreasing yield was the result of competitive pressures to obtain and retain quality credits. The average balance of loans to state and political subdivisions increased $5.1 million from 2012 to 2011 primarily as a result of municipalities in our area that continued to borrow funds to ensure compliance with U.S. Environmental Protection Agency laws and regulations impacting the Chesapeake Bay watershed. This had a positive impact of $253,000 on total interest income due to volume. Offsetting this, the average tax equivalent yield on loans to state and political subdivisions decreased from 5.20% in 2011 to 4.68% in 2012, decreasing interest income by $282,000. The decreasing yield was largely due to competitive pressures to obtain and retain quality credits in the current economic environment.

Total interest expense decreased $2,024,000 in 2012 compared to 2011. The decrease is primarily attributable to a change in average rate from 1.41% in 2011 to 1.09% in 2012, which had the effect of decreasing interest expense by $1,654,000. The low interest rate environment and economic conditions had the effect of decreasing our short-term borrowing costs as well as rates on all deposit products. The average balance of interest bearing liabilities increased $13.8 million from 2011 to 2012. While in total the average balance liabilities increased, certificates of deposit and other borrowed funds decreased $21.6 million and $3.0 million, respectively, which resulted a decrease in interest expense due to volume of $370,000.

The average balance of certificates of deposit decreased $21.6 million causing a decrease in interest expense of $428,000. In addition, there was a decrease in the average rate on certificates of deposit from 2.09% to 1.67% resulting in a decrease in interest expense of $1,262,000. The average balance of other borrowed funds decreased $3.0 million causing a decrease in interest expense of $91,000. In addition, there was a decrease in the average rate on other borrowed funds from 3.13% to 2.95% resulting in a decrease in interest expense of $102,000.

Our net interest spread for 2012 was 3.82% compared to 3.75% in 2011.

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2013, we recorded a provision for loan losses of $405,000. The expense for 2013 was $15,000, or 3.6% less than the same time period in 2012. The decrease in the provision for loan losses is the result of conditions of the Company’s loan portfolio remaining consistent with 2012 and the current economic conditions in the Company’s primary market place, as of December 31, 2013, which impacted management's quarterly review of the allowance for loan losses (see also “Financial Condition – Allowance for Loan Losses and Credit Quality Risk”).

For the year ended December 31, 2012, we recorded a provision for loan losses of $420,000, which represents a decrease of $255,000 or 37.8% over the same time period in 2011. The decrease in the provision for loan losses was the result of improved conditions in the Company’s loan portfolio compared to 2011.

NON-INTEREST INCOME

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

		2013		2012		2011
Service charges	$	4,299	$	4,475	$	4,380
Trust		694		644		665
Brokerage and insurance		444		392		352
Investment securities gains, net		441		604		334
Gains on loans sold		443		759		208
Earnings on bank owned life insurance		502		507		498
Other		446		456		479
Total	$	7,269	$	7,837	$	6,916

		2013/2012 Change			2012/2011 Change	
		Amount	%		Amount	%
Service charges	$	(176)	(3.9)	$	95	2.2
Trust		50	7.8		(21)	(3.2)
Brokerage and insurance		52	13.3		40	11.4
		(163)	(27.0)		270	80.8

Investment securities gains, net						
Gains on loans sold		(316)	(41.6)		551	264.9
Earnings on bank owned life insurance		(5)	(1.0)		9	1.8
Other		(10)	(2.2)		(23)	(4.8)
Total	$	(568)	(7.2)	$	921	13.3

2013 vs. 2012

Non-interest income decreased $568,000 in 2013 from 2012, or 7.2%. We recorded investment securities gains totaling $441,000 compared with net gains of $604,000 in 2012. During 2013 we elected to sell seven agency securities, nine mortgage backed securities, portions of three equity securities, four municipal securities and one corporate security for gains of $86,000, $356,000, $296,000, $87,000 and $2,000, respectively. We also sold one corporate security and two mortgage backed securities for losses of $246,000 and $140,000, respectively. The sales made during 2013 were primarily made as a result of market conditions at the time, which either minimized in managements opinion the loss that may result or provided for improved portfolio performance in the future regardless of changes in interest rates. During 2012, we elected to sell four agency securities, thirteen mortgage backed securities, portions of an equity security and one municipal security for total gains of $604,000 due to favorable market conditions.

Gains on loans sold decreased $316,000 compared to last year, which is the result of a lower level of refinancing done in 2013 versus 2012. During 2013, the Bank generated $21.9 million of loan sale proceeds, but this was $14.8 million or 40.4% less than the proceeds received in 2012.

Service charge income decreased by $176,000 in 2013 compared to 2012 and continues to be the Company's primary source of non-interest income. Service charge fees related to customers' usage of their debit cards decreased by $60,000 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 $53,000 in 2013 compared to 2012 due to decreased usage of the Company's ATM machines by non-customers. As a result of reduced drilling for natural gas in 2013, there were fewer temporary workers in the area working for companies' associated with the exploration of the Marcellus Shale who have not established permanent residency in the Company's primary market. Finally, there was a decrease in fees charged to customers for non-sufficient funds of $34,000. Management continues to monitor regulatory changes to determine the level of impact that these regulations will have on the Company.

The increase in trust revenues of $50,000 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 there was a significant withdrawal of trust assets by a single customer, which will impact future revenues until additional accounts or assets are added to those under management by the Trust department. The increase in brokerage and insurance revenues was primarily a result of increased customer brokerage activity as a result of increases in the stock market.

2012 vs. 2011

Non-interest income increased $921,000 in 2012 from 2011, or 13.3%. We recorded investment securities gains totaling $604,000 compared with net gains of $334,000 in 2011. During 2012, we elected to sell four agency securities, thirteen mortgage backed securities, portions of an equity security and one municipal security for total gains of $604,000. During 2011, we elected to sell three agency securities, thirteen mortgage backed securities, portions of two equity securities and one municipal security for total gains of $461,000. We sold three municipal bonds, one equity security and one mortgage backed security for losses totaling $73,000. Additionally, we recorded an other than temporary impairment charge of $54,000 related to one equity security due to the magnitude of the loss in relation to the security's cost basis.

Gains on loans sold in 2012 increased $551,000 compared to 2011, which is the result of the level of refinancing done in 2012 versus 2011. During 2012, due to the low interest rate environment, the Company sold $36.7 million of loans on the secondary market generating gains compared to $9.8 million of loans in 2011. Trust income decreased slightly in 2012 from 2011 due to a large estate settling in 2011 that resulted in significant revenues.

Service charge income increased by $95,000 in 2012 compared to 2011. Service charge fees related to customers' usage of their debit cards increased by $49,000. ATM income increased $31,000 in 2012 compared to 2011 due to a rate increase implemented midway through 2011 and additional usage of the Company's ATM machines by non-customers. Part of the increased usage by non-customers was associated with an influx of temporary workers working for companies' associated with the exploration of the Marcellus Shale who did not establish permanent residency in the Company's primary market. Finally, there was an increase in fees charged to customers for non-sufficient funds of $19,000.

Non-interest Expenses

The following tables reflect the breakdown of non-interest expense by major category for the periods ended December 31 (dollars in thousands):

	2013	2012	2011
Salaries and employee benefits	$ 11,392	$ 11,018	$ 9,996
Occupancy	1,271	1,265	1,331
Furniture and equipment	492	411	449
Professional fees	781	891	744
Federal depository insurance	450	468	592
ORE expenses	191	164	396
Pennsylvania shares tax	640	602	541
Other	4,439	4,478	4,360
Total	$ 19,656	$ 19,297	$ 18,409

	2013/2012 Change		2012/2011 Change	
	Amount	%	Amount	%
Salaries and employee benefits	$ 374	3.4	$ 1,022	10.2
Occupancy	6	0.5	(66)	(5.0)
Furniture and equipment	81	19.7	(38)	(8.5)
Professional fees	(110)	(12.3)	147	19.8
Federal depository insurance	(18)	(3.8)	(124)	(20.9)
ORE expenses	27	16.5	(232)	(58.6)
Pennsylvania shares tax	38	6.3	61	11.3
Other	(39)	(0.9)	118	2.7
Total	$ 359	1.9	$ 888	4.8

2013 vs. 2012

Non-interest expenses for 2013 totaled $19,656,000 which represents an increase of $359,000, compared with 2012 costs of $19,297,000. Salary and benefit costs increased $374,000. Base salaries and related payroll taxes increased $343,000, primarily due to merit increases and additional head count as a result of continuing to implement the Company’s strategic and expansion plans. Full time equivalent staffing was 186 and 181 employees for 2013 and 2012, respectively. Incentive costs decreased $65,000 compared to 2012 primarily due to lower net income in 2013. Retirement expenses increased $97,000 compared to 2012 as a result of increased expense for the pension plan and increased salary levels utilized in the calculation of the supplemental executive retirement plan.

Professional fees decreased as a result of fees and costs incurred in connection with the Bank's charter conversion and simultaneous name change that occurred in 2012. Furniture and equipment costs increased as a result purchasing equipment for the online teller system implemented during 2013.

2012 vs. 2011

Non-interest expenses for 2012 totaled $19,297,000 which represented an increase of $888,000, compared with 2011 costs of $18,409,000. Salary and benefit costs increased $1,022,000. Base salaries and related payroll taxes increased $574,000, primarily due to merit increases and additional head count as a result of implementing portions of the Company's strategic and expansion plans. Full time equivalent staffing was 181 and 174 employees for 2012 and 2011, respectively. Incentive costs increased $38,000 compared to 2011 primarily due to the attainment of certain corporate goals and objectives. Insurance costs for employees increased by $304,000 as a result of claims experience. Retirement expenses increased $94,000 compared to 2011 as a result of actuarial changes in the pension plan and increased salary levels utilized in the calculation of the supplemental executive retirement plan.

FDIC insurance decreased $124,000 in 2012 primarily due to changes in the FDIC assessment base and the assessment formula that was implemented during 2011 that was effective for all of 2012. Professional fees increased as a result fees and costs incurred in connection with the Bank's charter conversion and simultaneous name change. ORE expenses decreased as a result of selling several properties for gains in 2012 compared to losses in 2011. In addition, as a result of the sales, holding costs for ORE properties were also lower in 2012.

Provision for Income Taxes

The provision for income taxes was $3,752,000, $4,331,000 and $3,610,000 for 2013, 2012 and 2011, respectively. The effective tax rates for 2013, 2012 and 2011 were 21.9%, 23.4% and 22.0%, respectively.

Income before the provision for income taxes decreased by $1,419,000 in 2013 compared to 2012. This resulted in the provision for income taxes decreasing by $579,000 when compared to 2012. We have managed our effective tax rate by remaining invested in tax-exempt municipal loans and bonds and investments in certain partnerships that provide the Company with tax credits. The provision was impacted in 2013 by one partnership, which provided its first tax credits in 2013.

Income before the provision for income taxes increased by $2,104,000 in 2012 compared to 2011. This resulted in the provision for income taxes increasing by $721,000 when compared to 2011.

We are involved in four limited partnership agreements that established low-income housing projects in our market area. During 2013, we recognized tax credits related to two of the four partnerships, with credits being recognized for the first time on one partnership. The tax credits for the other two projects were fully utilized by December 31, 2012. We anticipate recognizing an aggregate of $1.4 million of tax credits over the next nine years.

FINANCIAL CONDITION

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

	2013 Balance	Increase	% Change	2012 Balance	Increase	% Change	2011 Balance
Total assets	$ 914.9	$ 32.5	3.7	$ 882.4	$ 3.8	0.4	$ 878.6
Total investments	317.3	7.0	2.3	310.3	(8.5)	(2.7)	318.8
Total loans, net	533.5	37.8	7.6	495.7	14.7	3.1	481.0
Total deposits	748.3	11.2	1.5	737.1	3.1	0.4	734.0
Total stockholders' equity	92.1	2.6	2.9	89.5	8.0	9.8	81.5

Cash and Cash Equivalents

Cash and cash equivalents totaled $10.1 million at December 31, 2013 compared with $26.3 million at December 31, 2012. The decrease in cash and cash equivalents is the result of the Company’s increased investment and loan portfolios offset by deposit and borrowed funds growth, as discussed in more detail below. Management actively measures and evaluates its liquidity through our Asset – Liability committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

Investments

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

	2013 Amount	% of Total	2012 Amount	% of Total	2011 Amount	% of Total	2010 Amount	% of Total	2009 Amount	% of Total
Available-for-sale:										
U. S. Agency securities	$ 152,189	48.0	$ 127,234	41.0	$ 168,600	52.9	$ 118,484	47.1	$ 65,223	32.8
U.S. Treasuries	11,309	3.6	4,947	1.6	-	-	-	-	-	-
Obligations of state & political subdivisions	95,005	29.9	100,875	32.5	101,547	31.9	76,922	30.6	59,574	30.0
Corporate obligations	16,802	5.3	22,109	7.1	8,460	2.7	8,681	3.5	3,166	1.6
Mortgage-backed securities	40,671	12.8	53,673	17.3	38,974	12.2	46,015	18.3	70,194	35.3
Equity securities	1,325	0.4	1,414	0.5	1,242	0.3	1,201	0.5	425	0.3
Total	$ 317,301	100.0	$ 310,252	100.0	$ 318,823	100.0	$ 251,303	100.0	$ 198,582	100.00

2013

The Company's investment portfolio increased by $7.0 million, or 2.3%, during the past year. During 2013, we purchased $90.8 million of U.S. agency obligations, $9.3 million of mortgage-backed securities, $14.8 million of state and local obligations, $1.7 million of corporate obligations, $6.9 million of U.S. treasury notes and $1,000 of equity securities, which help offset the $13.6 million of principal repayments and $65.0 million of calls and maturities that occurred during the year. We also selectively sold $25.5 million of bonds and equities at a net gain of $441,000. The market value of our investment portfolio decreased approximately $10.4 million in 2013 due to interest rate fluctuations. Excluding our short term investments consisting of monies held primarily at the Federal Reserve, the effective yield on our investment portfolio for 2013 was 2.90% compared to 3.18% for 2012 on a tax equivalent basis.

During 2013, rates on the short end of the curve experienced very little change, while the long end of the curve experienced a rise in excess of 100 basis points. This resulted in the market value of the investment portfolio decreasing. In addition, during the fourth quarter of 2013, the Federal Reserve reduced the amount of quantitative easing it was providing to the market and indicated that a further reduction could be expected, while at the same time committing to low short term rates. This has resulted in a relatively steep yield curve. As a result of these items, the investment strategy as of the end of 2013 has been to purchase agency securities with maturities of less than five years and high quality municipal bonds with high coupons. Due to the steepness of the yield curve of maturities between two to five years, the Bank believes it has provided itself protection to rising rates, if they occur. Additionally, high coupon municipal bonds have less price volatility in rising rate scenarios than similar lower coupon bonds. We believe this strategy will enable us to reinvest cash flows in the next two to five years when and if investment opportunities improve.

At December 31, 2013, the Company did not own any securities, other than government-sponsored and government-guaranteed mortgage-backed securities, that had an aggregate book value in excess of 10% of our total capital at that date.

2012

The Company's investment portfolio decreased by $8.6 million, or 2.7%, from 2011 to 2012. During 2012, we purchased $60.6 million of U.S. agency obligations, $36.5 million of mortgage-backed securities, $11.3 million of state and local obligations, $13.6 million of corporate obligations, $8.8 million of U.S. treasury notes and $140,000 of equity securities, which help offset the $16.0 million of principal repayments and $101.4 million of calls and maturities that occurred during the year. We also selectively sold $20.6 million of bonds and equities at a net gain of $604,000. The market value of our investment portfolio increased approximately $217,000 in 2012 due to market fluctuations. Excluding our short term investments consisting of monies held primarily at the Federal Reserve, the effective yield on our investment portfolio for 2012 was 3.18% compared to 3.52% for 2011 on a tax equivalent basis.

As a result of the Federal Reserve's commitment to a low rate policy in 2012, the Company implemented a strategy in 2012 to increase portfolio duration through the purchase of certain mortgage backed securities and longer term agencies to provide additional interest income. This strategy maintained a defensive posture to future rising rates by selecting securities that had limited extension risk. As part of implementing this strategy, the Company purchased agencies, corporate bonds, high quality municipal bond and mortgage backed securities of $60.6 million, $13.6 million, $11.3 million and $36.5 million, respectively.

The expected principal repayments (amortized cost) and average weighted yields for the investment portfolio as of December 31, 2013, are shown below (dollars in thousands). Expected principal repayments, which include prepayment speed assumptions for mortgage-backed securities, are significantly different than the contractual maturities detailed in Note 3 of the consolidated financial statements. Yields on tax-exempt securities are presented on a fully taxable equivalent basis, assuming a 34% tax rate.

	One Year or Less		After One Year to Five years		After Five Years to Ten Years		After Ten Years		Total	
	Amortized Cost	Yield %	Amortized Cost	Yield %	Amortized Cost	Yield %	Amortized Cost	Yield %	Amortized Cost	Yie %
Available-for-sale securities:										
U.S. agency securities	$ 55,150	1.4	$ 83,414	1.3	$ 15,332	1.8	$ -	-	$ 153,896	
U.S. treasuries	-	-	-	-	11,856	1.3	-	-	11,856	
Obligations of state & political subdivisions	6,807	5.9	66,480	5.2	20,826	5.3	-	-	94,113	
Corporate obligations	2,521	2.1	14,130	2.3	-	-	-	-	16,651	
Mortgage-backed securities	7,767	2.3	32,638	2.3	-	-	-	-	40,405	
Total available-for-sale	$ 72,245	2.0	$ 196,662	2.8	$ 48,014	2.9	$ -	-	$ 316,921	

Approximately 84.8% of the amortized cost of debt securities is expected to mature, call or pre-pay within five years or less. The Company expects that earnings from operations, the levels of cash held at the Federal Reserve and other correspondent banks, the high liquidity level of the available-for-sale securities, growth of deposits and the availability of borrowings from the Federal Home Loan Bank and other third party banks will be sufficient to meet future liquidity needs. Excluding, U.S Agency and Mortgage-backed securities, there are no securities from a single issuer representing more than 10% of stockholders' equity.

Loans

The Bank's lending efforts are focused within its market area located in North Central Pennsylvania and Southern New York. We originate loans primarily through direct loans to our existing customer base, with new customers generated by referrals from real estate brokers, building contractors, attorneys, accountants, existing customers and the Bank's website. The Bank offers a variety of loans although historically most of our lending has focused on real estate loans including residential, commercial, agricultural, and construction loans. As of December 31, 2013, approximately 76% of our loan portfolio consisted of real estate loans. All lending is governed by a lending policy that is developed and maintained by us and approved by the Board of Directors.

Primarily the Bank offers fixed rate residential mortgage loans with terms of up to 25 years and adjustable rate mortgage loans (with amortization schedules based up to 30 years) with interest rates and payments that adjust based on one, three, and five year fixed periods. Loan to value ratios are usually 80% or less with exceptions for individuals with excellent credit and low debt to income and/or high net worth. Adjustable rate mortgages are tied to a margin above the comparable Federal Home Loan Bank of Pittsburgh borrowing rate. Home equity loans are written with terms of up to 15 years at fixed rates. Home equity lines of credit are variable rate loans tied to the Prime Rate generally with a ten year draw period followed by a ten year repayment period. Home equity loans are typically written with a maximum 80% loan to value.

Commercial real estate loan terms are generally 20 years or less with one to five year adjustable rates. The adjustable rates are typically tied to a margin above the comparable Federal Home Loan Bank of Pittsburgh borrowing rate with a maximum loan to value ratio of 80%. Where feasible, the Bank works with the United States Department of Agriculture's (USDA) and Small Business Administration (SBA) guaranteed loan programs to offset risk and to further promote economic growth in our market area. During 2013, we originated $2.8 million in USDA and SBA guaranteed commercial real estate loans.

Agriculture, and particularly dairy farming, is an important industry in our market area. Therefore the Bank has developed an agriculture lending team with significant experience that has a thorough understanding of this industry. Agricultural loans focus on character, cash flow and collateral, while also taking into account the particular risks of the industry. Loan terms are generally 20 years or less with one to five year adjustable rates. The adjustable rates are typically tied to a margin above the comparable Federal Home Loan Bank of Pittsburgh borrowing rate with a maximum loan to value of 80%. The Bank is a preferred lender under the USDA's Farm Service Agency (FSA) and participates in the FSA guaranteed loan program.

The Bank, as part of its commitment to the communities it serves, is an active lender for projects by our local municipalities and school districts. These loans range from short term bridge financing to 20 year term loans for specific projects. These loans are typically written at rates that adjust at least every five years.

Over the past few years, we have experienced an increase in loan demand from companies and businesses associated with, and serving, the exploration of the Marcellus Shale gas field. Activities associated with this tend to be very cyclical. As a result, while we have pursued these opportunities, we have done so in a prudent and cautious manner and have developed specific policies and procedures for lending to these entities. The Bank has lowered the loan to value threshold for loans, shortened amortization periods, and expanded our monitoring of loan concentrations associated with this activity.

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

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

	2013		2012		2011		2010		2009	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate:										
Residential	$ 187,101	34.6	$ 178,080	35.4	$ 184,034	37.7	$185,012	39.1	$194,989	42.7
Commercial	193,087	35.7	176,710	35.2	165,826	34.0	152,499	32.2	133,953	29.4
Agricultural	22,001	4.1	18,015	3.6	19,224	3.9	19,078	4.0	19,485	4.2
Construction	8,937	1.7	12,011	2.4	8,481	1.7	9,766	2.1	5,619	1.2
Consumer	9,563	1.7	10,559	2.1	10,746	2.2	11,285	2.4	11,895	2.6
Other commercial and agricultural loans	54,029	10.0	47,880	9.5	44,299	9.1	47,156	10.0	44,101	9.7
State & political subdivision loans	65,894	12.2	59,208	11.8	54,899	11.4	48,721	10.2	46,342	10.2
Total loans	540,612	100.0	502,463	100.0	487,509	100.0	473,517	100.0	456,384	100.0
Less allowance for loan losses	7,098		6,784		6,487		5,915		4,888	
Net loans	$ 533,514		$ 495,679		$ 481,022		$467,602		$451,496	

	2013/2012 Change		2012/2011 Change	
	Amount	%	Amount	%
Real estate:				
Residential	$ 9,021	5.1	$ (5,954)	(3.2)
Commercial	16,377	9.3	10,884	6.6
Agricultural	3,986	22.1	(1,209)	(6.3)
Construction	(3,074)	(25.6)	3,530	41.6
Consumer	(996)	(9.4)	(187)	(1.7)
	6,149	12.8	3,581	8.1

Other commercial and agricultural loans						
State & political subdivision loans		6,686	11.3		4,309	7.8
Total loans	$	38,149	7.6	$	14,954	3.1

2013

Total loans grew $38.1 million in 2013 from a balance of $502.5 million at the end of 2012 to $540.6 million at the end of 2013. Total loans grew 7.6% in 2013 compared with a 3.1% loan growth rate in 2012.

During 2013, the Company experienced growth in commercial real estate loans which increased $16.4 million or 9.3%, residential real estate loans which increased $9.0 million or 5.1%, other commercial and agricultural loans which increased $6.1 million or 12.8% and state and political subdivision loans which increased $6.7 million or 11.3%. The growth in commercial real estate, other commercial and agricultural and state and political subdivision loans reflects the Company's focus on commercial lending 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. Commercial real estate and other commercial loan demand is subject to significant competitive pressures, the yield curve, the strength of the overall regional and national economy and the local economy. The local economy has been 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 2013, exploration activities were curtailed in comparison to 2012. We work closely with local municipalities and school districts to meet their needs that otherwise would be provided by the municipal bond market.

Residential real estate loans increased $9.0 million during 2013. Loan demand for conforming mortgages, which the Company typically sells on the secondary market, remained strong during 2013, although not as strong as 2012. During 2013, $20.2 million of loans were originated and placed for sale on the secondary market, which compares to $37.4 million for 2012. In addition, due to the decline in demand for non-conforming mortgages and the difficult investment environment in the first part of 2013, the Company decided 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 2013, the Company decided not to sell $7.5 million of residential mortgages that met secondary market standards, which accounts for the majority of the increase in residential loans. For loans sold on the secondary market, the Company recognizes fee income for servicing these sold loans, which is included in non-interest income. Management continues to explore new competitively priced products and to build technologies which make it easier and more efficient for customers to choose the Company for their mortgage needs.

The decrease in construction loans of $3.1 million is attributable to transfers out of construction at completion to commercial and residential real estate during 2013.

2012

Total loans grew $15.0 million in 2012 from a balance of $487.5 million at the end of 2011 to $502.5 million at the end of 2012. Total loans grew 3.1% in 2012 compared with a 3.0% loan growth rate in 2011.

During 2012, the Company experienced growth in commercial real estate loans which increased $10.9 million or 6.6%, construction loans which increased $3.5 million or 41.6%, other commercial and agricultural loans which increased $3.6 million or 8.1% and state and political subdivision loans which increased $4.3 million or 7.8%.

Residential real estate loans decreased $6.0 million, with the majority of the decrease occurring in the fourth quarter of 2012, while consumer loans decreased $187,000. The major factor impacting this decline is the demand for conforming rate loans. Loan demand for conforming mortgages, which the Company typically sells on the secondary market, increased substantially in 2012. During 2012, $37.4 million of loans were originated and marketed for sale, which compares to the $14.8 million of loans originated in 2011 of which $9.6 million were sold. During the fourth quarter of 2011, the Company decided that certain loans meeting secondary market standards would not be sold. In the middle of the first quarter of 2012, due to a further decline in interest rates, the Company resumed selling all loans originated after that time that met secondary market standards. These loans were sold to limit the Company's exposure to rising rate environments as the majority of the loans had fixed rates for a minimum of fifteen years, with the majority having fixed rates from twenty to thirty years.

The following table shows the maturity of commercial business and agricultural, state and political subdivision loans, commercial real estate loans, and construction loans as of December 31, 2013, classified according to the sensitivity to changes in interest rates within various time intervals (in thousands). The table does not include any estimate of prepayments which significantly shorten the average life of all loans and may cause our actual repayment experience to differ from that shown below. Demand loans having no stated schedule of repayments and no stated maturity are reported as due in one year or less. The amounts shown below exclude net deferred loan costs or fees.

	Commercial, municipal, agricultural	Real estate construction	Total
Maturity of loans:			
One year or less	$ 13,478	$ -	$ 13,478
Over one year through five years	42,329	-	42,329
Over five years	279,204	8,937	288,141
Total	$ 335,011	$ 8,937	$ 343,948
Sensitivity of loans to changes in interest rates - loans due after December 31, 2014:			
Predetermined fixed interest rate	$ 64,832	$ 966	$ 65,798
Floating or adjustable interest rate	256,701	7,971	264,672
Total	$ 321,533	$ 8,937	$ 330,470

Allowance for Loan Losses and Credit Quality Risk

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 change in the allowance for loan losses and a summary of our non-performing assets for the years ended December 31, 2013, 2012, 2011, 2010 and 2009. All non-accruing troubled debt restructurings are also included the non-accruing loans total.

	December 31,				
	2013	2012	2011	2010	2009
Balance at beginning of period	$ 6,784	$ 6,487	$ 5,915	$ 4,888	$ 4,378
Charge-offs:					
Real estate:					
Residential	17	95	101	147	76
Commercial	62	2	29	53	236
Agricultural	-	-	-	-	1
Consumer	54	54	71	35	80
Commercial and other loans	1	21	6	173	153
Total loans charged-off	134	172	207	408	546
Recoveries:					
Real estate:					
Residential	5	-	-	4	1

Commercial		5		9		15		11	1
Consumer		33		33		57		45	52
Commercial and other loans		-		7		32		120	77
Total loans recovered		43		49		104		180	131
Net loans charged-off		91		123		103		228	415
Provision charged to expense		405		420		675		1,255	925
Balance at end of year	$	7,098	$	6,784	$	6,487	$	5,915	$ 4,888
Loans outstanding at end of period	$	540,612	$	502,463	$	487,509	$	473,517	$ 456,384
Average loans outstanding, net	$	516,748	$	496,822	$	474,972	$	468,620	$ 442,921
Non-performing assets:									

34

Non-accruing loans	$	8,097	$	8,067	$	9,165	$	11,853	$ 5,871
Accrual loans - 90 days or more past due		697		506		275		692	884
Total non-performing loans	$	8,794	$	8,573	$	9,440	$	12,545	$ 6,755
Foreclosed assets held for sale		1,360		616		860		693	302
Total non-performing assets	$	10,154	$	9,189	$	10,300	$	13,238	$ 7,057
Troubled debt restructurings (TDR)									
Non-accruing TDRs	$	4,701	$	4,834	$	5,490	$	130	$ -
Accrual TDRs		2,510		193		123		-	-
Total troubled debt restructurings	$	7,211	$	5,027	$	5,613	$	130	$ -
Net charge-offs to average loans		0.02%		0.02%		0.02%		0.05%	0.09%
Allowance to total loans		1.31%		1.35%		1.33%		1.25%	1.07%
Allowance to total non-performing loans		80.71%		79.13%		68.72%		47.15%	72.36%
Non-performing loans as a percent of loans net of unearned income		1.63%		1.71%		1.94%		2.65%	1.48%
Non-performing assets as a percent of loans net of unearned income		1.88%		1.83%		2.11%		2.80%	1.55%

The Company utilizes a disciplined and thorough loan review process based upon our internal loan policy approved by the Company's Board of Directors. The purpose of the review is to assess loan quality, analyze delinquencies, identify problem loans, evaluate potential charge-offs and recoveries, and assess general overall economic conditions in the markets served. An external independent loan review is performed on our commercial portfolio semi-annually for the

Company. The external consultant is engaged to 1) review a minimum of 55% (60% of loans prior to 2013) of the dollar volume of the commercial loan portfolio on an annual basis, 2) review a sample of new commercial/agricultural loans originated in the last year, 3) review all relationships in aggregate over $500,000, 4) review all aggregate loan relationships over $100,000 which are over 90 days past due, classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate. As part of this review, our underwriting process and loan grading system is evaluated.

Management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate as of December 31, 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, 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 choose to include. Watch list loans are continually monitored going forward until satisfactory conditions exist that allow management to upgrade and remove the loan from the watchlist. 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 commercial business loans, on non-accrual are evaluated quarterly for impairment.

The adequacy of the allowance for loan losses is subject to a formal, quarterly analysis by management of the Company. In order to better analyze the risks associated with the loan portfolio, the entire portfolio is divided into several categories. As stated above, loans on non-accrual status are specifically reviewed for impairment and given a specific reserve, if appropriate. Loans evaluated and not found to be impaired are included with other performing loans, by category, by their respective homogenous pools. Three year average historical loss factors were calculated for each pool and applied to the performing portion of the loan category for 2013, 2012 and 2011. For 2010 and 2009, the historical loss factor was based on a five year average. This was changed as management believes the three year average is better representative of the inherent risks in the loan portfolio and more reflective of current trends. The historical loss factors for both reviewed and homogeneous pools are adjusted based upon the following qualitative factors:

· Level of and trends in delinquencies, impaired/classified loans

Change in volume and severity of past due loans

Volume of non-accrual loans

Volume and severity of classified, adversely or graded loans

· Level of and trends in charge-offs and recoveries

• Trends in volume, terms and nature of the loan portfolio

· Effects of any changes in risk selection and underwriting standards and any other changes in lending and recovery policies, procedures and practices

• Changes in the quality of the Bank's loan review system

· Experience, ability and depth of lending management and other relevant staff

• National, state, regional and local economic trends and business conditions

General economic conditions

Unemployment rates

Inflation / CPI

Changes in values of underlying collateral for collateral-dependent loans

• Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses.

· Existence and effect of any credit concentrations, and changes in the level of such concentrations

• Any change in the level of board oversight

See also "Note 4 – Loans and Related Allowance for Loan Losses" to the consolidated financial statements.

The balance in the allowance for loan losses was $7,098,000 or 1.31% of total loans as of December 31, 2013 as compared to $6,784,000 or 1.35% of loans as of December 31, 2012. The $314,000 increase is a result of a $405,000 provision for loan losses less net charge-offs of $91,000. 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 December 31:

	2013		2012		2011		2010		2009	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Residential	$ 946	34.6	$ 875	35.4	$ 805	37.7	$ 969	39.1	$ 801	42.7
Commercial, agricultural	4,558	39.8	4,437	38.8	4,132	37.9	3,380	36.2	2,864	33.6
Construction	50	1.7	38	2.4	15	1.7	22	2.1	20	1.2
Consumer	105	1.7	119	2.1	111	2.2	108	2.4	131	2.6
Other commercial and agricultural loans	942	10.0	728	9.5	674	9.1	983	10.0	918	9.7
State & political subdivision loans	330	12.2	271	11.8	235	11.4	137	10.2	93	10.2
Unallocated	167	N/A	316	N/A	515	N/A	316	N/A	61	N/A
Total allowance for loan losses	$ 7,098	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 the risk factors utilized in determining the allowance, the Bank’s allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 39.8% of the loan portfolio, 64.2% 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. Residential real estate loans comprise 34.6% of the loan portfolio as of December 31, 2013 and 13.3% of the allowance is assigned to this segment.

The following table identifies amounts of loans contractually past due 30 to 90 days and non-performing loans by loan category, as well as the change from December 31, 2012 to December 31, 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.

	December 31, 2013				December 31, 2012			
		Non-Performing Loans				Non-Performing Loans		
	30 - 90 Days Past Due	90 Days Past Due Accruing	Non-accrual	Total Non-Performing	30 - 90 Days Past Due	90 Days Past Past Due	Non-accrual	Total No Performi
Real estate:								
Residential	$ 1,006	$ 352	$ 685	$ 1,037	$ 1,108	$ 332	$ 663	$ 9
Commercial	215	344	7,247	7,591	597	152	7,042	7,
Agricultural	-	-	-	-	54	-	-	
Construction	-	-	-	-	-	-	-	
Consumer	132	1	15	16	87	4	-	
Other commercial loans	17	-	150	150	932	18	362	3
Total nonperforming loans	$ 1,370	$ 697	$ 8,097	$ 8,794	$ 2,778	$ 506	$ 8,067	$ 8,5

	Change in Non-Performing Loans 2013 / 2012	
	Amount	%
Real estate:		
Residential	$ 42	4.2
Commercial	397	5.5
Agricultural	-	-
Construction	-	-
Consumer	12	300.0
Other commercial loans	(230)	(60.5)
Total nonperforming loans	$ 221	2.6

The following table shows the distribution of non-performing loans by loan category (dollars in thousands) for the past five years as of December 31:

	Non-Performing Loans				
	2013	2012	2011	2010	2009
Real estate:					
Residential	$ 1,037	$ 995	$ 653	$ 711	$ 885
Commercial	7,591	7,194	8,270	8,161	2,498
Agricultural	-	-	-	2,241	2,094
Construction	-	-	-	-	749
Consumer	16	4	-	18	11
Commercial and other loans	150	380	517	1,414	429
	-	-	-	-	89

State & political subdivision loans					
Total nonperforming loans	8,794	8,573	9,440	12,545	6,755

For the year ended December 31, 2013, we recorded a provision for loan losses of $405,000 which compares to $420,000 for the same period in 2012, a decrease of $15,000. The small decrease is attributable to the continued low net charge-offs of the Company and the consistent level of non-performing loans from 2012 to 2013. Non-performing loans increased $221,000 or 2.62%, from December 31, 2012 to December 31, 2013 primarily as a result of one relationship, which is discussed below and has a balance of approximately $506,000 as of December 31, 2013. Approximately 70.3% of the Bank's non-performing loans are associated with the following four customer relationships:

- A commercial customer with a total loan relationship of $4.1 million secured by 164 residential properties was considered non-accrual as of December 31, 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 December 31, 2013, there is no specific reserve allocation as of December 31, 2013. 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 and a Trustee was appointed in January of 2014. We continue to monitor the bankruptcy proceedings to determine what if any impact this will have on the collateral and on the loan payments.
- A commercial customer with a relationship of approximately $669,000 was considered non-accrual as of December 31 2013. The entire balance 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. In the fourth quarter of 2013, a foreclosure proceeding was completed on a second loan with this customer, which resulted in an increase in other real estate owed of $299,000, Management reviewed the collateral and guarantees and determined that a specific reserve allocation of $19,000 for the remaining loan was required as of December 31, 2013.
- A commercial customer with a relationship of approximately $936,000 secured by real estate was considered non-accrual as of December 31, 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 December 31, 2013 based on the appraised value of collateral.
- A commercial customer with a relationship of approximately $506,000 secured by real estate was considered non-accrual as of December 31, 2013. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer. Management reviewed the collateral and a charge-off of $52,000 was recorded in the fourth quarter of 2013, which resulted in no specific reserve as of December 31, 2013.

The decrease in loans 30-89 days past due from December 31, 2012 to December 31, 2013 is the result of approximately $730,000 of loans with one customer being past due that were refinanced in the first quarter of 2013 and a $540,000 relationship as of December 31, 2012 that was placed on non-accrual status in 2013 and has a balance as of December 31, 2013 of $506,000, which is discussed above.

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

- 46.3% of the Company's non-performing loans are associated with one customer, while still experiencing financial difficulties has remained current with its payments.
- 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. Net charge-offs for both 2013 and 2012 were 0.02% of the total loan portfolio.
- The primary market of the Bank has a relatively stable real estate market and did 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. The local real estate market also did not realize the significant, and sometimes speculative, increases seen in other parts of the country. Finally, our market area is predominately centered in the Marcellus Shale natural gas exploration and drilling area, and while the activities associated with this exploration are cyclical, it has provided a positive impact on the value of local real estate.

Bank Owned Life Insurance

The Company holds bank owned life insurance policies to offset future employee benefit costs. The Bank is the sole beneficiary on the policies, and will provide the Bank with an asset that will generate earnings to partially offset the current costs of benefits, and eventually (at the death of the insured's) provide partial recovery of cash outflows associated with the benefits. As of December 31, 2013 and 2012, the cash surrender value of the life insurance was

$14.7 and $14.2 million, respectively. The change in cash surrender value, net of purchases, is recognized in the results of operations. The amounts recorded as non-interest income totaled $502,000, $507,000 and $498,000 in 2013, 2012 and 2011, respectively. The Company evaluates annually the risks associated with the life insurance policies, including limits on the amount of coverage and an evaluation of the various carriers’ credit ratings.

Other Assets

2013

Other assets increased $2.6 million in 2013 to $11.5 million from $8.9 million in 2012. As a result of the decrease in the market value of the Company's investment portfolio, net deferred taxes changed from a liability of $870,000 as of December 31, 2012 to an asset of $1,477,000 as of December 31, 2013. Due to increases in the market value of the assets included in the Bank's pension plan and contributions made by the Bank over time to the plan, the funded status of the plan changed from a liability of $1,256,000 as of December 31, 2012 to an asset of $780,000 as of December 31, 2013. Other real estate owned increased $744,000 in 2013 as a result of foreclosures. As a result of an increase in FHLB borrowings regulatory stock increased $361,000. These increases were offset by a decrease in prepaid FDIC insurance of $1,010,000 as the FDIC returned the prepayment for insurance in 2013 that was originally made in 2009.

2012

Other assets decreased to $8.9 million in 2012 from $9.0 million in 2011. Changes included a decrease in prepaid FDIC insurance of $416,000 as the Bank continued to utilize the prepayment the FDIC required to be made in 2009. Additionally, the Company was able to sell certain ORE properties, which resulted in a decrease of $244,000. These decreases were offset by an increase in regulatory stock of $264,000 that was a result of short term borrowings made in 2012 and an increase in the investment in tax credit partnerships of $388,000 as we completed the investment in another partnership during 2012.

Deposits

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

	2013			2012			2011		
		Amount	%		Amount	%		Amount	%
Non-interest-bearing deposits	$	85,585	11.4	$	89,494	12.1	$	85,605	11.6
NOW accounts		215,656	28.8		201,804	27.4		200,897	27.4
Savings deposits		95,678	12.8		87,836	11.9		79,659	10.8
Money market deposit accounts		85,038	11.4		83,423	11.3		67,223	9.2
Certificates of deposit		266,359	35.6		274,539	37.3		300,609	41.0
Total	$	748,316	100.0	$	737,096	100.0	$	733,993	100.0

	2013/2012 Change			2012/2011 Change		
		Amount	%		Amount	%
Non-interest-bearing deposits	$	(3,909)	(4.4)	$	3,889	4.5
NOW accounts		13,852	6.9		907	0.5
Savings deposits		7,842	8.9		8,177	10.3
Money market deposit accounts		1,615	1.9		16,200	24.1
Certificates of deposit		(8,180)	(3.0)		(26,070)	(8.7)
Total	$	11,220	1.5	$	3,103	0.4

2013

Total deposits increased $11.2 million in 2013, or 1.5%. Our market continues to be impacted by the Marcellus Shale gas exploration activities through bonus payments upon lease signing, surface disturbances to landowners for pipeline right of ways and pad development, royalty checks to landowners and Pennsylvania Act 13 impact fees paid to local governments, who have been impacted by the exploration activities. The activity in 2013, however, was not as significant as prior years.

Non-interest bearing deposits decreased $3.9 million, or 4.4% in 2013. As a percentage of total deposits, non-interest bearing deposits totaled 11.4% as of the end of 2013, which compares to 12.1% at the end of 2012. In order to manage our overall cost of funds, the Company continues to focus on adding low cost deposits by having a free checking product available for retail customers. Additionally, our business development officers and branch personnel are focused on providing outstanding customer service and developing larger deposit relationships with our commercial customers.

NOW accounts increased by $13.8 million, or 6.9%, money market deposit accounts increased by $1.6 million or 1.9% and savings deposits increased $7.8 million, or 8.9%, since the end of 2012. A portion of the increase in NOW accounts, money market accounts and savings deposits is offset by the decrease in certificates of deposits of $8.2 million from 2012 to 2013. As in 2012, during 2013 the Company continued to lower rates paid on certificates of deposits, which continued to result in certain customers transferring funds they traditionally deposited in certificates of deposits to more liquid accounts that still paid interest.

2012

Total deposits increased $3.1 million in 2012, or .4%. Our market continued to be impacted by the Marcellus Shale gas exploration activities during 2012; however the impact was less than that experienced in 2011 and 2010. The majority of the acreage in the Company's primary markets was leased prior to 2012, and as a result, landowners did not receive large bonus payments as they did in 2011 and 2010. Additionally, due to the low natural gas prices experienced across the country, those landowners receiving royalty checks experienced significant decreases thus lowering their monthly deposits. Furthermore, due to returns in the stock market, certain customers of the Bank proceeded to purchase investment products through both the Company's brokers and external brokerage firms.

Non-interest bearing deposits increased $3.9 million, or 4.5% in 2012. As a percentage of total deposits, non-interest bearing deposits totaled 12.1% as of the end of 2012, which compares to 11.6% at the end of 2011. NOW accounts increased by $907,000, or .5%, money market deposit accounts increased by $16.2 million or 24.1% and savings deposits increased $8.2 million, or 10.3%, since the end of 2010. A portion of the increase in money market accounts and savings deposits is related to the decrease in certificates of deposits of $26.1 million from 2011 to 2012. Throughout 2012, the Company continued to lower rates paid on certificates of deposits to a point where certain customers transferred funds they traditionally deposited in certificates of deposits to more liquid accounts that still paid interest. Additionally, in the second half of 2012, local government entities received a portion of their share of impact fees assessed to Companies exploring for natural gas, which resulted in a significant influx of deposits.

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

	2013	2012	2011
3 months or less	$ 13,699	$ 15,348	$ 17,135
Over 3 months through 6 months	11,118	10,216	14,300
Over 6 months through 12 months	37,289	28,953	36,726
Over 12 months	55,836	58,962	51,966
Total	$ 117,942	$ 113,479	$ 120,127
As a percent of total certificates of deposit	44.28%	41.33%	39.96%

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

	2013		2012		2011	
	Amount	%	Amount	%	Amount	%
Individuals	$ 462,268	61.8	$ 464,764	63.1	$ 484,523	66.0
Businesses and other organizations	143,082	19.1	142,659	19.3	138,340	18.9
State & political subdivisions	142,966	19.1	129,673	17.6	111,130	15.1
Total	$ 748,316	100.0	$ 737,096	100.0	$ 733,993	100.0

Borrowed Funds

2013

Borrowed funds increased $20.8 million during 2013, or 45.1%. The increase was associated with an increase of $43.0 million of short term borrowings from the Federal Home Loan Bank. The increase in short term borrowings was offset by a decrease of $20.8 million of terms loans and a decrease of $1.4 in repurchase agreements. Term loans decreased from $30.0 million as of December 31, 2012 to $9.2 million as of December 31, 2013 (see Note 9 of the consolidated financial statements for additional information). Due to the rate environment in 2013, no new term loans were obtained and maturities in 2013 were funded with short term borrowings. Management will continue to monitor interest rates and to minimize interest rate risk in future years may extend some of the short term borrowings via term notes. During 2013, the balance of sweep repurchase agreements decreased $1.4 million, with the majority of the decrease associated with two customers. As of December 31, 2012, there were no outstanding short term borrowings from the Federal Home Loan Bank.

2012

Borrowed funds decreased $7.8 million during 2012, or 14.4%. The majority of the decrease was associated with term loans maturing with the Federal Home Loan Bank. Term loans decreased $5.0 million from $35.0 million as of December 31, 2011 to $30 million as of December 31, 2012 (see Note 9 of the consolidated financial statements for additional information). During 2012, no new term loans were obtained. During 2012, the balance of sweep repurchase agreements decreased $2.8 million, with the majority of the decrease, $1.9 million associated with one customer ending their agreement. As of December 31, 2012 and 2011, there were no outstanding short term borrowings from the Federal Home Loan Bank

Other Liabilities

2013

Other liabilities decreased $1,852,000 during 2013, or 21.6%. The primary driver of this decrease was associated with changes to other assets as discussed above. Due to decreases in the market value of the Bank's investment portfolio, the Bank's deferred tax liability of $870,000 as of December 31, 2012 became a deferred tax asset of $1,477,000, which accounts for $870,000 of the decrease in other liabilities. Additionally, due to the return on assets included in the pension plan and the contribution in 2013, the funded status of the pension plan changed from a liability of $1.3 million as of December 31, 2012 to an asset of $780,000 as of December 31, 2013, which accounts for a decrease of $1.3 million.

2012

Other liabilities increased $875,000 during 2012, or 11.3%. The majority of the increase is attributable to an increase in the pension liability of $342,000, which was attributable to the actual return on pension plan assets and changes in the discount rate utilized to determine the liability.

Stockholders' Equity

We evaluate stockholders' equity in relation to total assets and the risk associated with those assets. The greater our capital resources, the greater the likelihood of meeting our cash obligations and absorbing unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance. Due its importance, we develop a capital plan and stress test capital levels using various assumptions annually to ensure that in the event of unforeseen circumstances, we would remain in compliance with our capital plan approved by the Board of Directors and regulatory requirement levels.

Our Board of Directors determines our dividend rate after considering our capital requirements, current and projected net income, and other factors. In 2013 and 2012, the Company paid out 27.6% and 32.4% of net income in dividends, respectively. The dividends paid in 2012 included an acceleration of 2013's first quarter dividend, which amounted to $0.38 per share. The dividend was accelerated to benefit the Company's shareholders that could have been significantly impacted by issues in Washington D.C. regarding the very complex fiscal cliff tax issues that were not resolved until the final hours of 2012.

For the year ended December 31, 2013, the total number of common shares outstanding was 3,015,049. For comparative purposes, outstanding shares for prior periods were adjusted for the June 2013 stock dividend in computing earnings and cash dividends per share as detailed in Note 1 of the consolidated financial statements. During 2013, we purchased 31,092 shares of treasury stock at a weighted average cost of $47.70 per share. The Company awarded 3,027 shares of restricted stock to employees and 810 shares to the Board of Directors under equity incentive programs.

There are currently three federal regulatory measures of capital adequacy. The Company’s ratios meet the regulatory standards for well capitalized for 2013 and 2012, as detailed in Note 14 of the consolidated financial statements.

2013

Stockholders’ equity increased 2.9% in 2013 to $92.1 million. Excluding accumulated other comprehensive income, which is the after-tax effect of unrealized holding gains and losses on available-for-sale securities, additional pension obligation and unrealized loss on interest rate swap, stockholders’ equity increased $8.4 million, or 9.9%. This increase is due to net income of $13,375,000, offset by net cash dividends of $3,558,000 and the purchase of treasury stock of $1,483,000. All of the Company’s investment securities are classified as available-for-sale, making this portion of the Company’s balance sheet more sensitive to the changing market value of investments. Accumulated other comprehensive income (loss) decreased $5,856,000 from December 31, 2012 primarily as result of the decrease in the fair market value of the investment portfolio as a result of the rise in long term interest rates in 2013. Total equity was approximately 10.06% of total assets as of December 31, 2013, compared to 10.14% of total assets as of December 31, 2012.

2012

Stockholders’ equity increased 9.8% in 2012 to $89.5 million. Excluding accumulated other comprehensive income stockholders’ equity increased $8.3 million, or 10.9%. This increase is due to net income of $14,215,000, offset by net cash dividends of $4,601,000 and the purchase of treasury stock of $1,348,000. Accumulated other comprehensive income decreased $318,000 from December 31, 2011 primarily as result of changes in the Company’s pension obligation. Total equity was approximately 10.14% of total assets as of December 31, 2012, compared to 9.27% of total assets as of December 31, 2011.

LIQUIDITY

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

To maintain proper liquidity, we use funds management policies along with our investment and asset liability policies to assure we can meet our financial obligations to depositors, credit customers and stockholders. Management monitors liquidity by reviewing loan demand, investment opportunities, deposit pricing and the cost and availability of borrowing funds. Additionally, the bank has established various limits and ratios to monitor liquidity. On a quarterly basis, we stress test our liquidity position to ensure that the Bank has the capability of meetings its cash flow requirements in the event of unforeseen circumstances. The Company’s historical activity in this area can be seen in the Consolidated Statement of Cash Flows from investing and financing activities.

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

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

Capital expenditures in 2013 totaled $328,000, which included:

Implemented an online teller system totaling $126,000
New ATM's and upgraded software to meet the Americans with Disabilities Act requirements totaling $53,000
Vehicle purchases for employee use totaling $46,000
Engineering and architect fees for a potential bank expansion $40,000
Copier and printer upgrades totaling $27,000

Capital expenditures in 2012 totaled $438,000, which included:

Repairs to parking lots at various facilities totaling $125,000
New signs as a result of the Bank's charter conversion totaling $48,000
New ATM's and upgraded software to meet the Americans with Disabilities Act requirements totaling $117,000

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

In addition, to the Bank's cash balances, the Bank achieves additional liquidity primarily from its investment in the Federal Home Loan Bank of Pittsburgh and the resulting borrowing capacity obtained through this investment, investments that mature in less than one year and expected principal repayments from mortgage backed securities. The Bank has a maximum borrowing capacity at the Federal Home Loan Bank of approximately $250.8 million, inclusive of any outstanding amounts, as a source of liquidity. The Bank also had a federal funds line with a third party provider in the amount of $10.0 million as of December 31, 2013, which is unsecured and a borrower in custody agreement was established with the FRB in the amount of $13.6 million, which is collateralized by $16.6 million of municipal loans.

The Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company is responsible for paying any dividends declared to its shareholders. The Company also has repurchased shares of its common stock. The Company's primary source of income is dividends received from the Bank. The Bank may not declare a dividend without approval of the FRB, 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. In addition, the Bank can only pay dividends to the extent that its retained net profits (including the portion transferred to surplus) exceed its bad debts. The FRB, the OCC, the PDB 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 December 31, 2013, the Company had liquid assets of $1.6 million.

CONTRACTUAL OBLIGATIONS

The Company has various financial obligations, including contractual obligations which may require cash payments. The following table presents as of December 31, 2013, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the obligations can be found in Notes 8, 9 and 16 to the Consolidated Financial Statements.

Contractual Obligations	One year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Deposits without a stated maturity	$ 481,957	$ -	$ -	$ -	$ 481,957
Time deposits	133,491	91,368	36,278	5,222	266,359
FHLB Advances	42,954	-	-	-	42,954
Long-term borrowings - FHLB	4,200	-	3,000	2,000	9,200
Note Payable	7,500	-	-	-	7,500
Repurchase agreements	6,069	1,209	-	-	7,278
Operating leases	80	100	78	266	524
Total	$ 676,251	$ 92,677	$ 39,356	$ 7,488	$ 815,248

OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of operations, we engage in a variety of financial transactions that, in accordance with generally accepted accounting principles are not recorded in our financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customers' requests for funding and take the form of loan commitments, unused lines of credit and letters of credit. For information about our loan commitments, unused lines of credit and letters of credit, see Note 15 of the notes to consolidated financial statements.

For the year ended December 31, 2013, we did not engage in any off-balance sheet transactions reasonably likely to have a material effect on our financial condition, results of operations or cash flows.

INTEREST RATE AND MARKET RISK MANAGEMENT

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

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

Currently, our Company has equity securities that represent only 0.4% of our investment portfolio, and therefore equity risk is not significant.

The primary factors that make assets interest-sensitive include adjustable-rate features on 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, repurchase agreements and short-term borrowings. Savings deposits, NOW accounts and money market investor accounts are considered core deposits and are not short-term interest sensitive and therefore are included in the table below in the over five year column (except for the top-tier money market investor and NOW accounts which are paid current market interest rates).

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

Maturity or Re-pricing of Company Assets and Liabilities as of December 31, 2013

	Within Three Months	Four to Twelve Months	One to Two Years	Two to Three Years	Three to Five Years	Over Five Years	Total
Interest-earning assets:							
Interest-bearing deposits at banks	$ 1,184	$ -	$ -	$ -	$ 2,480	$ -	$ 3,664
Investment securities	10,309	38,466	41,928	39,274	90,812	96,512	317,301
Residential mortgage loans	25,930	44,851	42,258	31,386	30,397	12,279	187,101
Construction loans	573	1,777	990	-	5,597	-	8,937
Commercial and farm loans	88,326	43,143	46,132	38,703	35,529	17,284	269,117
Loans to state & political subdivisions	8,303	4,306	16,461	5,095	8,644	23,085	65,894
Other loans	2,618	2,538	2,153	1,106	1,016	132	9,563
Total interest-earning assets	$ 137,243	$ 135,081	$ 149,922	$ 115,564	$ 174,475	$ 149,292	$ 861,577
Interest-bearing liabilities:							
NOW accounts	$ 129,352	$ -	$ -	$ -	$ -	$ 86,304	$ 215,656
Savings accounts	-	-	-	-	-	95,678	95,678
Money Market accounts	73,469	-	-	-	-	11,569	85,038
Certificates of deposit	34,516	98,975	55,317	36,051	36,278	5,222	266,359
Short-term borrowing	48,523	-	-	-	-	-	48,523
Long-term borrowing	9,000	3,200	675	534	3,000	2,000	18,409
Total interest-bearing liabilities	$ 294,860	$ 102,175	$ 55,992	$ 36,585	$ 39,278	$ 200,773	$ 729,663
Excess interest-earning							
assets (liabilities)	$ (157,617)	$ 32,906	$ 93,930	$ 78,979	$ 135,197	$ (51,481)	
Cumulative interest-earning assets	$ 137,243	$ 272,324	$ 422,246	$ 537,810	$ 712,285	$ 861,577	
	294,860	397,035	453,027	489,612	528,890	729,663	

Cumulative interest-bearing liabilities						
Cumulative gap	$ (157,617)	$ (124,711)	$ (30,781)	$ 48,198	$ 183,395	$ 131,914
Cumulative interest rate						
sensitivity ratio (1)	0.47	0.69	0.93	1.10	1.35	1.18

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

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

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

The Bank 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 and asset liability management processes that we believe will effectively identify, measure, and monitor the Bank's risk exposure. In this analysis, the Bank examines the results of movements in interest rates with additional assumptions made concerning prepayment speeds on mortgage loans and mortgage securities. Shock scenarios, which assume a parallel shift in interest rates and is instantaneous, typically have the greatest impact on net interest income. The following is a rate shock analysis and the impact on net interest income as of December 31, 2013 (dollars in thousands):

Changes in Rates	Prospective One-Year Net Interest Income	Change In Prospective Net Interest Income	% Change In Prospective Net Interest Income
-100 Shock	$ 29,691	$ (315)	(1.1)
Base	30,006		
+100 Shock	28,971	(1,035)	(3.5)
+200 Shock	27,798	(2,208)	(7.4)
+300 Shock	26,666	(3,340)	(11.1)
+400 Shock	25,506	(4,500)	(15.0)

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

CRITICAL ACCOUNTING POLICIES

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

Other than Temporary Impairment

All securities are evaluated periodically to determine whether a decline in their value is other than temporary and is a matter of judgment. For debt securities, 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.

Allowance for Loan Losses

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

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

Goodwill and Other Intangible Assets

As discussed in Note 1 of the consolidated financial statements, the Company must assess goodwill and other intangible assets each year for impairment. This assessment involves estimating the fair value of the Company's reporting units. If the fair value of the reporting unit is less than its carrying value including goodwill, we would be required to take a charge against earnings to write down the assets to the lower value.

Deferred Tax Assets

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

ITEM 7A – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

This information is included under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations", appearing in this Annual Report on Form 10-K.

ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Citizens Financial Services, Inc.
Consolidated Balance Sheet

(in thousands, except share data)		December 31, 2013		2012
ASSETS:				
Cash and cash equivalents:				
Noninterest-bearing	$	8,899	$	12,307
Interest-bearing		1,184		14,026
Total cash and cash equivalents		10,083		26,333
Interest bearing time deposits with other banks		2,480		-
Available-for-sale securities		317,301		310,252
Loans held for sale		278		1,458
Loans (net of allowance for loan losses: 2013, $7,098; 2012, $6,784)		533,514		495,679
Premises and equipment		11,105		11,521
Accrued interest receivable		3,728		3,816
Goodwill		10,256		10,256
Bank owned life insurance		14,679		14,177
Other assets		11,510		8,935
TOTAL ASSETS	$	914,934	$	882,427
LIABILITIES:				
Deposits:				
Noninterest-bearing	$	85,585	$	89,494
Interest-bearing		662,731		647,602
Total deposits		748,316		737,096
Borrowed funds		66,932		46,126
Accrued interest payable		895		1,143
Other liabilities		6,735		8,587
TOTAL LIABILITIES		822,878		792,952
STOCKHOLDERS' EQUITY:				
Preferred Stock $1.00 par value; authorized 3,000,000 shares 2013 and 2012; none issued in 2013 or 2012		-		-
Common Stock				
$1.00 par value; authorized 15,000,000 shares 2013 and 2012; issued 3,305,517 and 3,161,324 shares in 2013 and 2012, respectively		3,306		3,161
Additional paid-in capital		23,562		16,468
Retained earnings		74,325		71,813
Accumulated other comprehensive (loss) income		(1,225)		4,631

Treasury stock, at cost:				
290,468 and 262,921 shares for 2013 and 2012, respectively		(7,912)		(6,598)
TOTAL STOCKHOLDERS' EQUITY		92,056		89,475
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	914,934	$	882,427

See accompanying notes to consolidated financial statements.

Citizens Financial Services, Inc.
Consolidated Statement of Income
Year Ended December 31,

(in thousands, except per share data)		2013		2012		2011
INTEREST AND DIVIDEND INCOME:						
Interest and fees on loans	$	28,982	$	29,770	$	29,916
Interest-bearing deposits with banks		40		21		81
Investment securities:						
Taxable		3,721		4,521		4,575
Nontaxable		3,405		3,702		3,666
Dividends		86		71		55
TOTAL INTEREST AND DIVIDEND INCOME		36,234		38,085		38,293
INTEREST EXPENSE:						
Deposits		5,107		6,113		7,944
Borrowed funds		1,208		1,546		1,739
TOTAL INTEREST EXPENSE		6,315		7,659		9,683
NET INTEREST INCOME		29,919		30,426		28,610
Provision for loan losses		405		420		675
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES		29,514		30,006		27,935
NON-INTEREST INCOME:						
Service charges		4,299		4,475		4,380
Trust		694		644		665
Brokerage and insurance		444		392		352
Investment securities gains, net		441		604		334
Gains on loans sold		443		759		208
Earnings on bank owned life insurance		502		507		498
Other		446		456		479
TOTAL NON-INTEREST INCOME		7,269		7,837		6,916
NON-INTEREST EXPENSES:						
Salaries and employee benefits		11,392		11,018		9,996
Occupancy		1,271		1,265		1,331
Furniture and equipment		492		411		449
Professional fees		781		891		744
Federal depository insurance		450		468		592
Pennsylvania shares tax		640		602		541
Other		4,630		4,642		4,756
TOTAL NON-INTEREST EXPENSES		19,656		19,297		18,409
Income before provision for income taxes		17,127		18,546		16,442

Provision for income taxes		3,752		4,331		3,610
NET INCOME	$	13,375	$	14,215	$	12,832
PER COMMON SHARE DATA:						
NET INCOME – BASIC	$	4.42	$	4.65	$	4.16
NET INCOME - DILUTED	$	4.42	$	4.65	$	4.16
CASH DIVIDENDS PER SHARE	$	1.22	$	1.51	$	1.09
Number of shares used in computation - basic		3,025,315		3,056,078		3,087,221
Number of shares used in computation - diluted		3,026,485		3,057,720		3,087,221

See accompanying notes to consolidated financial statements.

Citizens Financial Services, Inc.
Consolidated Statement of Changes in Comprehensive Income
Year Ended December 31,

(in thousands)	2013	2012	2011
Net Income	$ 13,375	$ 14,215	$ 12,832
Other comprehensive (loss) income			
Securities available for sale			
Change in net unrealized gain/loss during the period	(9,955)	821	7,114
Income tax expense (benefit)	(3,384)	278	2,419
	(6,571)	543	4,695
Reclassification adjustment for gains included in income	(441)	(604)	(334)
Income tax benefit	(150)	(205)	(114)
	(291)	(399)	(220)
Change in unrealized loss on interest rate swap	200	148	61
Income tax expense	68	50	21
	132	98	40
Change in unrecognized pension costs	1,325	(848)	(939)
Income tax expense (benefit)	451	(288)	(319)
	874	(560)	(620)
Net other comprehensive income (loss)	(5,856)	(318)	3,895
Comprehensive income	$ 7,519	$ 13,897	$ 16,727

See accompanying notes to consolidated financial statements.

Citizens Financial Services, Inc.
Consolidated Statement of Changes in Stockholders' Equity

	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	Treasury	
(in thousands, except share data)	Shares	Amount	Capital	Earnings	Income (Loss)	Stock	Total
Balance, December 31, 2010	3,104,434	$ 3,104	$ 14,235	$ 54,932	$ 1,054	$ (4,635)	$ 68,690
Net income				12,832			12,832
Net other comprehensive income					3,895		3,895
Stock dividend	28,432	29	1,023	(1,052)			-
Purchase of treasury stock (24,247 shares)						(851)	(851)
Restricted stock awards			(159)				(159)
Restricted stock vesting			209				209
Cash dividend reinvestment paid from treasury stock			5	(227)		222	-
Cash dividends, $1.09 per share				(3,148)			(3,148)
Balance, December 31, 2011	3,132,866	3,133	15,313	63,337	4,949	(5,264)	81,468
Net income				14,215			14,215
Net other comprehensive loss					(318)		(318)
Stock dividend	28,458	28	1,110	(1,138)			-
Purchase of treasury stock (33,042 shares)						(1,348)	(1,348)
Restricted stock awards			(156)			14	(142)
Restricted stock vesting			201				201
Cash dividends, $1.51 per share				(4,601)			(4,601)
	3,161,324	3,161	16,468	71,813	4,631	(6,598)	89,475

Balance, December 31, 2012				
Net income		13,375		13,375
Net other comprehensive loss			(5,856)	(5,856)
Stock dividend	144,193			