

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
November 06, 2014

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

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

For the quarterly period ended September 30, 2014  
Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-13222

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

PENNSYLVANIA  
(State or other jurisdiction of incorporation or organization)

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

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of outstanding shares of the Registrant's Common Stock, as of October 28, 2014, was 3,041,904.

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

| (in thousands except share data)  | September 30<br>2014 | December<br>31<br>2013 |
|---|----------------------|------------------------|
| <b>ASSETS:</b>  |                      |                        |
| Cash and due from banks:  |                      |                        |
| Noninterest-bearing   | \$ 10,889            | \$ 8,899               |
| Interest-bearing  | 434                  | 1,184                  |
| Total cash and cash equivalents   | 11,323               | 10,083                 |
| Interest bearing time deposits with other banks   | 5,712                | 2,480                  |
| Available-for-sale securities   | 308,283              | 317,301                |
| Loans held for sale   | 753                  | 278                    |
| Loans (net of allowance for loan losses:<br>2014, \$6,816 and 2013, \$7,098)  | 536,939              | 533,514                |
| Premises and equipment  | 11,773               | 11,105                 |
| Accrued interest receivable   | 3,689                | 3,728                  |
| Goodwill  | 10,256               | 10,256                 |
| Bank owned life insurance   | 15,045               | 14,679                 |
| Other assets  | 9,272                | 11,510                 |
| <b>TOTAL ASSETS</b>   | <b>\$ 913,045</b>    | <b>\$ 914,934</b>      |
| <b>LIABILITIES:</b>   |                      |                        |
| Deposits:   |                      |                        |
| Noninterest-bearing   | \$ 94,049            | \$ 85,585              |
| Interest-bearing  | 673,993              | 662,731                |
| Total deposits  | 768,042              | 748,316                |
| Borrowed funds  | 37,729               | 66,932                 |
| Accrued interest payable  | 753                  | 895                    |
| Other liabilities   | 7,361                | 6,735                  |
| <b>TOTAL LIABILITIES</b>  | <b>813,885</b>       | <b>822,878</b>         |
| <b>STOCKHOLDERS' EQUITY:</b>  |                      |                        |
| Preferred Stock   |                      |                        |
| \$1.00 par value; authorized 3,000,000 shares September 30, 2014 and December 31, 2013;                                   |                      |                        |
| none issued in 2014 or 2013   | -                    | -                      |
| Common stock  |                      |                        |
| \$1.00 par value; authorized 15,000,000 shares; issued 3,335,236 at September 30, 2014 and 3,305,517 at December 31, 2013 |                      |                        |
|   | 3,335                | 3,306                  |
| Additional paid-in capital  | 25,140               | 23,562                 |

|   |            |            |
|---|------------|------------|
| Retained earnings   | 77,252     | 74,325     |
| Accumulated other comprehensive income (loss)   | 1,513      | (1,225)    |
| Treasury stock, at cost: 293,332 shares at September 30, 2014 and 290,468 shares at December 31, 2013 | (8,080)    | (7,912)    |
| TOTAL STOCKHOLDERS' EQUITY  | 99,160     | 92,056     |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY  | \$ 913,045 | \$ 914,934 |

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

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

|  | Three Months Ended<br>September 30 |              | Nine Months Ended<br>September 30 |               |
|--|------------------------------------|--------------|-----------------------------------|---------------|
| (in thousands, except<br>share and per share data)                     | 2014                               | 2013         | 2014                              | 2013          |
| <b>INTEREST INCOME:</b>  |                                    |              |                                   |               |
| Interest and fees on loans   | \$ 7,094                           | \$ 7,521     | \$ 21,200                         | \$ 21,799     |
| Interest-bearing deposits<br>with banks                                | 25                                 | 8            | 51                                | 27            |
| Investment securities:   |                                    |              |                                   |               |
| Taxable  | 805                                | 905          | 2,542                             | 2,804         |
| Nontaxable   | 844                                | 850          | 2,526                             | 2,563         |
| Dividends  | 40                                 | 23           | 159                               | 61            |
| <b>TOTAL INTEREST<br/>INCOME</b>                                       | <b>8,808</b>                       | <b>9,307</b> | <b>26,478</b>                     | <b>27,254</b> |
| <b>INTEREST EXPENSE:</b>   |                                    |              |                                   |               |
| Deposits   | 1,092                              | 1,279        | 3,291                             | 3,894         |
| Borrowed funds   | 142                                | 283          | 451                               | 951           |
| <b>TOTAL INTEREST<br/>EXPENSE</b>                                      | <b>1,234</b>                       | <b>1,562</b> | <b>3,742</b>                      | <b>4,845</b>  |
| <b>NET INTEREST<br/>INCOME</b>   | <b>7,574</b>                       | <b>7,745</b> | <b>22,736</b>                     | <b>22,409</b> |
| Provision for loan losses  | 150                                | 90           | 480                               | 315           |
| <b>NET INTEREST<br/>INCOME AFTER<br/>PROVISION FOR<br/>LOAN LOSSES</b> | <b>7,424</b>                       | <b>7,655</b> | <b>22,256</b>                     | <b>22,094</b> |
| <b>NON-INTEREST<br/>INCOME:</b>  |                                    |              |                                   |               |
| Service charges  | 1,098                              | 1,145        | 3,239                             | 3,313         |
| Trust  | 151                                | 169          | 528                               | 539           |
| Brokerage and insurance  | 141                                | 120          | 398                               | 333           |
| Investment securities<br>gains, net                                    | 242                                | 91           | 488                               | 385           |
| Gains on loans sold  | 40                                 | 75           | 110                               | 236           |
| Earnings on bank owned<br>life insurance                               | 124                                | 127          | 366                               | 377           |
| Other  | 128                                | 124          | 337                               | 328           |
| <b>TOTAL<br/>NON-INTEREST<br/>INCOME</b>                               | <b>1,924</b>                       | <b>1,851</b> | <b>5,466</b>                      | <b>5,511</b>  |
| <b>NON-INTEREST<br/>EXPENSES:</b>                                      |                                    |              |                                   |               |
|  | 2,790                              | 2,856        | 8,600                             | 8,456         |

Salaries and employee  
benefits

|   |          |          |          |           |
|---|----------|----------|----------|-----------|
| Occupancy                                   | 313      | 302      | 967      | 956       |
| Furniture and equipment                     | 86       | 157      | 280      | 372       |
| Professional fees                           | 289      | 187      | 731      | 604       |
| FDIC insurance                              | 116      | 112      | 345      | 337       |
| Pennsylvania shares tax                     | 101      | 183      | 485      | 548       |
| Other                                       | 1,372    | 1,168    | 3,750    | 3,411     |
| <b>TOTAL</b>                                |          |          |          |           |
| <b>NON-INTEREST</b>                         |          |          |          |           |
| <b>EXPENSES</b>                             | 5,067    | 4,965    | 15,158   | 14,684    |
| Income before provision<br>for income taxes | 4,281    | 4,541    | 12,564   | 12,921    |
| Provision for income<br>taxes               | 913      | 1,029    | 2,655    | 2,842     |
| <b>NET INCOME</b>                           | \$ 3,368 | \$ 3,512 | \$ 9,909 | \$ 10,079 |

**PER COMMON SHARE**  
**DATA:**

|                      |          |          |          |          |
|----------------------|----------|----------|----------|----------|
| Net Income - Basic   | \$ 1.11  | \$ 1.15  | \$ 3.26  | \$ 3.29  |
| Net Income - Diluted | \$ 1.11  | \$ 1.15  | \$ 3.26  | \$ 3.29  |
| Cash Dividends Paid  | \$ 1.000 | \$ 0.281 | \$ 1.772 | \$ 0.829 |

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Number of shares used in<br>computation - basic   | 3,035,214 | 3,054,226 | 3,038,973 | 3,059,520 |
| Number of shares used in<br>computation - diluted | 3,036,700 | 3,055,709 | 3,040,400 | 3,060,808 |

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

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

| (in thousands)  | Three Months Ended |          | Nine Months Ended |           |
|---|--------------------|----------|-------------------|-----------|
|   | September 30,      |          | September 30,     |           |
|   | 2014               | 2013     | 2014              | 2013      |
|   | \$                 |          |                   |           |
| Net income  | 3,368              | \$ 3,512 | \$ 9,909          | \$ 10,079 |
| Other comprehensive<br>income (loss):   |                    |          |                   |           |
| Change in unrealized<br>gains on available<br>for sale<br>securities                            | 855                | (183)    | 4,598             | (8,215)   |
| Income tax effect   | (291)              | 62       | (1,563)           | 2,793     |
| Change in<br>unrecognized pension<br>cost   | 13                 | 66       | 38                | 194       |
| Income tax effect   | (4)                | (22)     | (13)              | (66)      |
| Change in unrealized<br>loss on interest rate swap  | -                  | 53       | -                 | 154       |
| Income tax effect   | -                  | (18)     | -                 | (52)      |
| Less: Reclassification<br>adjustment for investment<br>security gains<br>included in net income | (242)              | (91)     | (488)             | (385)     |
| Income tax effect   | 82                 | 30       | 166               | 130       |
| Other comprehensive<br>income (loss), net of tax  | 413                | (103)    | 2,738             | (5,447)   |
|   | \$                 |          |                   |           |
| Comprehensive income  | 3,781              | \$ 3,409 | \$ 12,647         | \$ 4,632  |

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



CITIZENS FINANCIAL  
SERVICES, INC.  
CONSOLIDATED  
STATEMENT OF CASH  
FLOWS

|   | Nine Months Ended |           |
|---|-------------------|-----------|
|   | September 30,     |           |
| (in thousands)  | 2014              | 2013      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                   |           |
| Net income  | \$ 9,909          | \$ 10,079 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |           |
| Provision for loan losses   | 480               | 315       |
| Depreciation and amortization   | 358               | 318       |
| Amortization and accretion of investment securities                               | 1,632             | 1,837     |
| Deferred income taxes   | 562               | 570       |
| Investment securities gains, net  | (488)             | (385)     |
| Earnings on bank owned life insurance   | (366)             | (377)     |
| Originations of loans held for sale   | (8,055)           | (17,039)  |
| Proceeds from sales of loans held for sale  | 7,690             | 18,473    |
| Realized gains on loans sold  | (110)             | (236)     |
| Decrease in accrued interest receivable   | 39                | 1         |
| Decrease in accrued interest payable  | (142)             | (172)     |
| Other, net  | (222)             | (495)     |
| Net cash provided by operating activities   | 11,287            | 12,889    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                   |           |
| Available-for-sale securities:  |                   |           |
| Proceeds from sales   | 17,338            | 15,894    |
| Proceeds from maturity and principal repayments                                   | 39,416            | 64,380    |
| Purchase of securities  | (44,769)          | (98,526)  |
| Purchase of interest bearing time deposits with other banks                       | (3,232)           | (2,480)   |
| Proceeds from redemption of regulatory stock                                      | 2,891             | 1,186     |
| Purchase of regulatory stock  | (1,895)           | (563)     |
| Net increase in loans   | (4,680)           | (19,800)  |

|   |                  |                  |
|---|------------------|------------------|
| Purchase of premises and equipment                      | (555)            | (339)            |
| Proceeds from sale of foreclosed assets held for sale   | 647              | 151              |
| Net cash provided by (used in) investing activities     | 5,161            | (40,097)         |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>            |                  |                  |
| Net increase in deposits                                | 19,726           | 21,560           |
| Proceeds from long-term borrowings                      | 6,815            | -                |
| Repayments of long-term borrowings                      | (4,200)          | (10,800)         |
| Net (decrease) increase in short-term borrowed funds    | (31,818)         | 7,837            |
| Purchase of treasury and restricted stock               | (733)            | (1,431)          |
| Dividends paid  | (4,998)          | (2,535)          |
| Net cash (used) provided by financing activities        | (15,208)         | 14,631           |
| Net (decrease) increase in cash and cash equivalents    | 1,240            | (12,577)         |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b> | <b>10,083</b>    | <b>26,333</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>       | <b>\$ 11,323</b> | <b>\$ 13,756</b> |

**Supplemental Disclosures of Cash Flow Information:**

|  |          |          |
|--|----------|----------|
| Interest paid  | \$ 3,884 | \$ 5,017 |
| Income taxes paid                                    | \$ 2,085 | \$ 2,945 |
| Loans transferred to foreclosed property             | \$ 867   | \$ 62    |
| Premises and equipment transferred from other assets | \$ 549   | \$ -     |

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

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

Note 1 - Basis of Presentation

Citizens Financial Services, Inc. (individually and collectively with its direct and indirect subsidiaries, the “Company”) is a Pennsylvania corporation organized as the holding company of its wholly owned subsidiary, First Citizens Community Bank (the “Bank”), and the Bank’s subsidiary, First Citizens Insurance Agency, Inc. (“First Citizens Insurance”).

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) and in conformity with U.S. generally accepted accounting principles. Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. Certain of the prior year amounts have been reclassified to conform with the current year presentation. Such reclassifications had no effect on net income or stockholders’ equity. All material inter-company balances and transactions have been eliminated in consolidation.

In the opinion of management of the Company, the accompanying interim financial statements for the periods ended September 30, 2014 and 2013 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the period. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. The financial performance reported for the Company for the nine month period ended September 30, 2014 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

Note 2 - Earnings per Share

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

|  | Three months ended<br>September 30, |             | Nine months ended<br>September 30, |              |
|--|-------------------------------------|-------------|------------------------------------|--------------|
|  | 2014                                | 2013        | 2014                               | 2013         |
| Net income applicable to common stock                | \$3,368,000                         | \$3,512,000 | \$9,909,000                        | \$10,079,000 |
| Basic earnings per share computation                 |                                     |             |                                    |              |
| Weighted average common shares outstanding           | 3,035,214                           | 3,054,226   | 3,038,973                          | 3,059,520    |
| Earnings per share - basic                           | \$1.11                              | \$1.15      | \$3.26                             | \$3.29       |
| Diluted earnings per share computation               |                                     |             |                                    |              |
| Weighted average common shares outstanding for basic | 3,035,214                           | 3,054,226   | 3,038,973                          | 3,059,520    |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| earnings per share   |           |           |           |           |
| Add: Dilutive effects of restricted stock                                  | 1,486     | 1,483     | 1,427     | 1,288     |
| Weighted average common shares outstanding for dilutive earnings per share | 3,036,700 | 3,055,709 | 3,040,400 | 3,060,808 |
| Earnings per share - diluted   | \$1.11    | \$1.15    | \$3.26    | \$3.29    |

For the three months ended September 30, 2014 and 2013, there were 1,938 and 1,037 shares, respectively, related to the restricted stock program that were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had prices ranging from \$34.70-\$50.50 for the three month period ended September 30 2014 and prices ranging from \$36.00-\$44.50 for the three month period ended September 30, 2013. For the nine months ended September 30, 2014 and 2013, 2,913 and 3,280 shares, respectively, related to the restricted stock program were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had prices ranging from \$34.70-\$50.50 for the nine month period ended September 30, 2014 and prices ranging from \$34.70-\$44.50 for the nine month period ended September 30, 2013.

## Note 3 - Income Tax Expense

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

## Note 4 – Investments

The amortized cost and fair value of investment securities at September 30, 2014 and December 31, 2013 were as follows (in thousands):

|   | Amortized  | Gross               | Gross                | Fair       |
|---|------------|---------------------|----------------------|------------|
| September 30,<br>2014                                       | Cost       | Unrealized<br>Gains | Unrealized<br>Losses | Value      |
| Available-for-sale securities:                              |            |                     |                      |            |
| U.S. agency securities                                      | \$ 146,993 | \$ 503              | \$ (1,011)           | \$ 146,485 |
| U.S. treasury securities                                    | 11,873     | -                   | (343)                | 11,530     |
| Obligations of state and political subdivisions             | 96,830     | 3,784               | (191)                | 100,423    |
| Corporate obligations                                       | 13,923     | 250                 | (73)                 | 14,100     |
| Mortgage-backed securities in government sponsored entities | 33,581     | 486                 | (85)                 | 33,982     |
| Equity securities in financial institutions                 | 1,136      | 647                 | (20)                 | 1,763      |
| Total available-for-sale securities                         | \$ 304,336 | \$ 5,670            | \$ (1,723)           | \$ 308,283 |
| December 31, 2013   |            |                     |                      |            |
| Available-for-sale securities:                              |            |                     |                      |            |
| U.S. agency securities                                      | \$ 153,896 | \$ 702              | \$ (2,409)           | \$ 152,189 |
| U.S. treasury securities                                    | 11,856     | -                   | (547)                | 11,309     |
| Obligations of state and political subdivisions             | 94,113     | 2,146               | (1,254)              | 95,005     |

|   |            |          |            |            |
|---|------------|----------|------------|------------|
| Corporate obligations                                       | 16,651     | 341      | (190)      | 16,802     |
| Mortgage-backed securities in government sponsored entities | 40,405     | 566      | (300)      | 40,671     |
| Equity securities in financial institutions                 | 542        | 783      | -          | 1,325      |
| Total available-for-sale securities                         | \$ 317,463 | \$ 4,538 | \$ (4,700) | \$ 317,301 |

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, which individual securities have been in a continuous unrealized loss position, at September 30, 2014 and December 31, 2013 (in thousands). As of September 30, 2014, the Company owned 76 securities whose fair value was less than their cost basis.

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| September 30,<br>2014                                       | Less than Twelve Months |                               | Twelve Months or Greater |                               | Total         |                               |
|---|-------------------------|-------------------------------|--------------------------|-------------------------------|---------------|-------------------------------|
|   | Fair<br>Value           | Gross<br>Unrealized<br>Losses | Fair<br>Value            | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses |
| U.S. agency securities                                      | \$ 49,419               | \$ (202)                      | \$ 43,395                | \$ (809)                      | \$ 92,814     | \$ (1,011)                    |
| U.S. treasury securities                                    | -                       | -                             | 11,530                   | (343)                         | 11,530        | (343)                         |
| Obligations of state and political subdivisions             | 2,324                   | (18)                          | 11,431                   | (173)                         | 13,755        | (191)                         |
| Corporate obligations                                       | 505                     | (2)                           | 7,781                    | (71)                          | 8,286         | (73)                          |
| Mortgage-backed securities in government sponsored entities | 2,309                   | (5)                           | 4,733                    | (80)                          | 7,042         | (85)                          |
| Equity securities in financial institutions                 | 581                     | (20)                          | -                        | -                             | 581           | (20)                          |
| Total securities  | \$ 55,138               | \$ (247)                      | \$ 78,870                | \$ (1,476)                    | \$ 134,008    | \$ (1,723)                    |
| December 31, 2013   |                         |                               |                          |                               |               |                               |
| U.S. agency securities                                      | \$ 98,356               | \$ (2,212)                    | \$ 2,825                 | \$ (197)                      | \$ 101,181    | \$ (2,409)                    |
| U.S. treasury securities                                    | 11,309                  | (547)                         | -                        | -                             | 11,309        | (547)                         |
| Obligations of states and political subdivisions            | 24,201                  | (865)                         | 6,491                    | (389)                         | 30,692        | (1,254)                       |
| Corporate obligations                                       | 6,103                   | (124)                         | 2,251                    | (66)                          | 8,354         | (190)                         |
| Mortgage-backed securities in government sponsored entities | 23,920                  | (266)                         | 1,164                    | (34)                          | 25,084        | (300)                         |
| Total securities  | \$ 163,889              | \$ (4,014)                    | \$ 12,731                | \$ (686)                      | \$ 176,620    | \$ (4,700)                    |

As of September 30, 2014, the Company's investment securities portfolio contained unrealized losses on agency securities issued or backed by the full faith and credit of the United States government or are generally viewed as having the implied guarantee of the U.S. government, U.S treasuries, obligations of states and political subdivisions, corporate obligations, mortgage backed securities in government sponsored entities and equity securities in financial institutions. For fixed maturity investments management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an impairment loss unless sufficient evidence is available that the decline is not other than temporary and a recovery period can be predicted. The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not other than temporary and is the result of interest rate changes, sector credit rating changes, or company-specific rating changes that are not expected to result in the non-collection of principal and interest during the period.

Proceeds from sales of securities available-for-sale for the nine months ended September 30, 2014 and 2013 were \$17,338,000 and \$15,894,000, respectively. For the three months ended September 30, 2014 and 2013, there were sales of \$5,187,000 and \$121,000, respectively, of available-for-sale securities. The gross gains and losses were as follows (in thousands):



|              | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |        |
|--------------|-------------------------------------|-------|------------------------------------|--------|
|              | 2014                                | 2013  | 2014                               | 2013   |
| Gross gains  | \$ 242                              | \$ 91 | \$ 488                             | \$ 525 |
| Gross losses | -                                   | -     | -                                  | (140)  |
| Net gains    | \$ 242                              | \$ 91 | \$ 488                             | \$ 385 |

Investment securities with an approximate carrying value of \$189.1 million and \$194.7 million at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public funds and certain other deposits.

Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and fair value of debt securities at September 30, 2014, by contractual maturity, are shown below (in thousands):

|  | Amortized<br>Cost | Fair Value |
|--|-------------------|------------|
| Available-for-sale debt securities:    |                   |            |
| Due in one year or less                | \$ 11,726         | \$ 11,879  |
| Due after one year through five years  | 129,401           | 129,523    |
| Due after five years through ten years | 61,345            | 61,461     |
| Due after ten years                    | 100,728           | 103,657    |
| Total                                  | \$ 303,200        | \$ 306,520 |

#### Note 5 – Loans

The Company grants loans primarily to customers throughout North Central Pennsylvania and Southern New York. Although the Company had a diversified loan portfolio at September 30, 2014 and December 31, 2013, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions. The following table summarizes the primary segments of the loan portfolio and how those segments are analyzed within the allowance for loan losses as of September 30, 2014 and December 31, 2013 (in thousands):

| September 30,<br>2014       | Total Loans | Individually<br>evaluated for<br>impairment | Collectively<br>evaluated for<br>impairment |
|-----------------------------|-------------|---|---|
| Real estate loans:          |             |   |   |
| Residential                 | \$ 187,315  | \$ 324                                      | \$ 186,991                                  |
| Commercial and agricultural | 211,888     | 6,333                                       | 205,555                                     |

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|  |            |          |         |
|--|------------|----------|---------|
| Construction                                   | 4,960      | -        | 4,960   |
| Consumer                                       | 8,798      | -        | 8,798   |
| Other commercial<br>and agricultural<br>loans  | 56,664     | 1,942    | 54,722  |
| State and<br>political<br>subdivision<br>loans | 74,130     | -        | 74,130  |
| Total  | 543,755 \$ | 8,599 \$ | 535,156 |
| Allowance for<br>loan losses                   | 6,816      |          |         |
| Net loans                                      | \$ 536,939 |          |         |

| December 31,<br>2013                          | Total Loans       | Individually<br>evaluated for<br>impairment | Collectively<br>evaluated for<br>impairment |
|---|-------------------|---|---|
| Real estate loans:                            |                   |   |   |
| Residential                                   | \$ 187,101        | \$ 342                                      | \$ 186,759                                  |
| Commercial<br>and agricultural                | 215,088           | 8,310                                       | 206,778                                     |
| Construction                                  | 8,937             | -   | 8,937                                       |
| Consumer                                      | 9,563             | 15  | 9,548                                       |
| Other commercial<br>and agricultural<br>loans | 54,029            | 1,733                                       | 52,296                                      |
| State and political<br>subdivision loans      | 65,894            | -   | 65,894                                      |
| <b>Total</b>                                  | <b>540,612</b>    | <b>10,400</b>                               | <b>530,212</b>                              |
| Allowance for<br>loan losses                  | 7,098             |   |   |
| <b>Net loans</b>                              | <b>\$ 533,514</b> |   |   |

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

Management considers commercial loans, other agricultural loans, state and political subdivision loans, commercial real estate loans and agricultural real estate loans which are 90 days or more past due to be impaired. Management will also consider a loan impaired based on other factors it becomes aware of, including the customer's results of operations and cash flows or if the loan is modified in a troubled debt restructuring. In addition, certain residential mortgages, home equity and consumer loans that are cross collateralized with commercial relationships that are determined to be impaired may also be classified as impaired. Impaired loans are analyzed to determine if it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allocation of the allowance for loan losses or a charge-off to the allowance for loan losses.

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



|  | Unpaid<br>Principal | Recorded<br>Investment<br>With No | Recorded<br>Investment<br>With | Total<br>Recorded | Related<br>Investment<br>Allowance |
|--|---------------------|-----------------------------------|--------------------------------|-------------------|------------------------------------|
| September 30,<br>2014                          | Balance             | Allowance                         | Allowance                      | Investment        | Allowance                          |
| Real estate<br>loans:                          |                     |                                   |                                |                   |                                    |
| Mortgages                                      | \$ 224              | \$ 128                            | \$ 67                          | \$ 195            | \$ 13                              |
| Home<br>Equity                                 | 131                 | 63                                | 66                             | 129               | 12                                 |
| Commercial                                     | 8,584               | 5,456                             | 877                            | 6,333             | 97                                 |
| Agricultural                                   | -                   | -                                 | -                              | -                 | -                                  |
| Construction                                   | -                   | -                                 | -                              | -                 | -                                  |
| Consumer                                       | -                   | -                                 | -                              | -                 | -                                  |
| Other<br>commercial<br>loans                   | 2,020               | 1,188                             | 754                            | 1,942             | 36                                 |
| Other<br>agricultural<br>loans                 | -                   | -                                 | -                              | -                 | -                                  |
| State and<br>political<br>subdivision<br>loans | -                   | -                                 | -                              | -                 | -                                  |
| Total  | \$ 10,959           | \$ 6,835                          | \$ 1,764                       | \$ 8,599          | \$ 158                             |

|  |           |          |          |           |        |
|--|-----------|----------|----------|-----------|--------|
| December 31,<br>2013                           |           |          |          |           |        |
| Real estate<br>loans:                          |           |          |          |           |        |
| Mortgages                                      | \$ 232    | \$ 138   | \$ 70    | \$ 208    | \$ 14  |
| Home<br>Equity                                 | 134       | 65       | 69       | 134       | 13     |
| Commercial                                     | 9,901     | 6,335    | 1,975    | 8,310     | 305    |
| Agricultural                                   | -         | -        | -        | -         | -      |
| Construction                                   | -         | -        | -        | -         | -      |
| Consumer                                       | 15        | 15       | -        | 15        | -      |
| Other<br>commercial<br>loans                   | 1,794     | 1,679    | 54       | 1,733     | 1      |
| Other<br>agricultural<br>loans                 | -         | -        | -        | -         | -      |
| State and<br>political<br>subdivision<br>loans | -         | -        | -        | -         | -      |
| Total  | \$ 12,076 | \$ 8,232 | \$ 2,168 | \$ 10,400 | \$ 333 |

The following tables includes the average balance of impaired financing receivables by class and the income recognized on impaired loans for the three and nine month periods ended September 30, 2014 and 2013(in thousands):

|  | For the Nine Months ended         |                                  |  |                                   |                                  |  |
|--|-----------------------------------|----------------------------------|--|-----------------------------------|----------------------------------|--|
|  | September 30, 2014                |                                  |  | September 30, 2013                |                                  |  |
|  | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis |
| Real estate<br>loans:                          |                                   |                                  |  |                                   |                                  |  |
| Mortgages                                      | \$ 201                            | \$ 7                             | \$ -   | \$ 336                            | \$ 6                             | \$ -   |
| Home<br>Equity                                 | 131                               | 3                                | -  | 136                               | 3                                | -  |
| Commercial                                     | 7,616                             | 66                               | -  | 8,521                             | 426                              | 361  |
| Agricultural                                   | -                                 | -                                | -  | -                                 | -                                | -  |
| Construction                                   | -                                 | -                                | -  | -                                 | -                                | -  |
| Consumer                                       | 13                                | -                                | -  | 2                                 | -                                | -  |
| Other<br>commercial<br>loans                   | 1,982                             | 61                               | -  | 1,740                             | 58                               | -  |
| Other<br>agricultural<br>loans                 | -                                 | -                                | -  | -                                 | -                                | -  |
| State and<br>political<br>subdivision<br>loans | -                                 | -                                | -  | -                                 | -                                | -  |
| Total  | \$ 9,943                          | \$ 137                           | \$ -   | \$ 10,735                         | \$ 493                           | \$ 361   |

|  | For the Three Months Ended        |                                  |  |                                   |                                  |  |
|--|-----------------------------------|----------------------------------|--|-----------------------------------|----------------------------------|--|
|  | September 30, 2014                |                                  |  | September 30, 2013                |                                  |  |
|  | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis |
| Real estate<br>loans:                          |                                   |                                  |  |                                   |                                  |  |
| Mortgages                                      | \$ 197                            | \$ 3                             | \$ -   | \$ 349                            | \$ 2                             | \$ -   |
| Home   |                                   |                                  |  |                                   |                                  |  |
| Equity   | 130                               | 1                                | -  | 135                               | 1                                | -  |
| Commercial                                     | 6,770                             | 22                               | -  | 8,372                             | 342                              | 326  |
| Agricultural                                   | -                                 | -                                | -  | -                                 | -                                | -  |
| Construction                                   | -                                 | -                                | -  | -                                 | -                                | -  |
| Consumer                                       | 10                                | -                                | -  | 5                                 | -                                | -  |
| Other<br>commercial<br>loans                   | 1,943                             | 15                               | -  | 1,647                             | 17                               | -  |
| Other<br>agricultural<br>loans                 | -                                 | -                                | -  | -                                 | -                                | -  |
| State and<br>political<br>subdivision<br>loans | -                                 | -                                | -  | -                                 | -                                | -  |
| Total  | \$ 9,050                          | \$ 41                            | \$ -   | \$ 10,508                         | \$ 362                           | \$ 326   |

#### Credit Quality Information

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

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

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

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

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay loan as agreed, the Bank's loan rating process includes several layers of internal and external oversight. The Company's loan officers are responsible for the timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under the supervision of management. All commercial, agricultural and municipal loans are reviewed annually to ensure the appropriateness of the loan grade. In addition, the Bank engages an external consultant on at least an annual basis. The external consultant is engaged to 1) review a minimum of 55% of the dollar volume of the commercial loan portfolio on an annual basis, 2) review new loans over \$1.0 million originated in the last year, 3) review a majority of relationships in aggregate over \$1.0 million, 4) review selected aggregate loan relationships over \$750,000 which are over 30 days past due classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate.



The following tables represent credit exposures by internally assigned grades as of September 30, 2014 and December 31, 2013 (in thousands):

| September 30,<br>2014                 | Pass              | Special<br>Mention | Substandard      | Doubtful | Loss        | Ending Balance |
|---------------------------------------|-------------------|--------------------|------------------|----------|-------------|----------------|
| Real estate loans:                    |                   |                    |                  |          |             |                |
| Commercial                            | \$ 165,424        | \$ 8,993           | \$ 13,275        | \$ -     | \$ -        | 187,692        |
| Agricultural                          | 19,109            | 2,963              | 2,124            | -        | -           | 24,196         |
| Construction                          | 4,960             | -                  | -                | -        | -           | 4,960          |
| Other commercial loans                |                   |                    |                  |          |             |                |
|                                       | 36,982            | 4,996              | 3,160            | 7        | -           | 45,145         |
| Other agricultural loans              |                   |                    |                  |          |             |                |
|                                       | 9,597             | 452                | 1,470            | -        | -           | 11,519         |
| State and political subdivision loans |                   |                    |                  |          |             |                |
|                                       | 74,130            | -                  | -                | -        | -           | 74,130         |
| <b>Total</b>                          | <b>\$ 310,202</b> | <b>\$ 17,404</b>   | <b>\$ 20,029</b> | <b>7</b> | <b>\$ -</b> | <b>347,642</b> |

|                                       |                   |                 |                  |            |             |                |
|---------------------------------------|-------------------|-----------------|------------------|------------|-------------|----------------|
| December 31, 2013                     |                   |                 |                  |            |             |                |
| Real estate loans:                    |                   |                 |                  |            |             |                |
| Commercial                            | \$ 166,956        | \$ 4,645        | \$ 21,284        | \$ 202     | \$ -        | 193,087        |
| Agricultural                          | 15,923            | 1,910           | 4,168            | -          | -           | 22,001         |
| Construction                          | 8,937             | -               | -                | -          | -           | 8,937          |
| Other commercial loans                |                   |                 |                  |            |             |                |
|                                       | 40,798            | 1,747           | 1,938            | 5          | -           | 44,488         |
| Other agricultural loans              |                   |                 |                  |            |             |                |
|                                       | 7,431             | 153             | 1,957            | -          | -           | 9,541          |
| State and political subdivision loans |                   |                 |                  |            |             |                |
|                                       | 65,894            | -               | -                | -          | -           | 65,894         |
| <b>Total</b>                          | <b>\$ 305,939</b> | <b>\$ 8,455</b> | <b>\$ 29,347</b> | <b>207</b> | <b>\$ -</b> | <b>343,948</b> |

For residential real estate mortgages, home equity and consumer loans, credit quality is monitored based on whether the loan is performing or non-performing, which is typically based on the aging status of the loan and payment activity, unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. Non-performing loans include those loans that are considered nonaccrual, described in more detail below and all loans past due 90 or more days and still accruing. The following table presents the recorded investment in those loan classes based on payment activity as of September 30, 2014 and December 31, 2013 (in thousands):

| September<br>30, 2014 | Performing    | Non-performing | Total      |
|-----------------------|---------------|----------------|------------|
| Real estate<br>loans: |               |                |            |
| Mortgages \$          | 122,393 \$    | 991 \$         | 123,384    |
| Home                  |               |                |            |
| Equity                | 63,577        | 354            | 63,931     |
| Consumer              | 8,748         | 50             | 8,798      |
| Total                 | \$ 194,718 \$ | 1,395 \$       | \$ 196,113 |

December 31,  
2013

|                       |               |          |            |
|-----------------------|---------------|----------|------------|
| Real estate<br>loans: |               |          |            |
| Mortgages \$          | 119,075 \$    | 809 \$   | 119,884    |
| Home                  |               |          |            |
| Equity                | 66,989        | 228      | 67,217     |
| Consumer              | 9,547         | 16       | 9,563      |
| Total                 | \$ 195,611 \$ | 1,053 \$ | \$ 196,664 |

#### Age Analysis of Past Due Financing Receivables

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table includes an aging analysis of the recorded investment of past due financing receivables as of September 30, 2014 and December 31, 2013 (in thousands):

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|                                       | 30-59<br>Days | 60-89<br>Days | 90 Days<br>Or Greater | Total Past<br>Due | Total Financing<br>Current | Total Financing<br>Receivables | 90 Days and<br>Accruing |
|---------------------------------------|---------------|---------------|-----------------------|-------------------|----------------------------|--------------------------------|-------------------------|
| September 30, 2014                    |               |               |                       |                   |                            |                                |                         |
| Real estate loans:                    |               |               |                       |                   |                            |                                |                         |
| Mortgages                             | 277           | 196           | 807                   | 1,280             | 122,104                    | 123,384                        | 257                     |
| Home Equity                           | 505           | 51            | 330                   | 886               | 63,045                     | 63,931                         | 175                     |
| Commercial                            | 484           | 22            | 1,309                 | 1,815             | 185,877                    | 187,692                        | 331                     |
| Agricultural                          | 12            | -             | -                     | 42                | 24,154                     | 24,196                         | -                       |
| Construction                          | -             | -             | -                     | -                 | 4,960                      | 4,960                          | -                       |
| Consumer                              | 53            | 3             | -                     | 56                | 8,742                      | 8,798                          | -                       |
| Other commercial loans                | 21            | -             | 343                   | 364               | 44,781                     | 45,145                         | -                       |
| Other agricultural loans              | -             | -             | -                     | -                 | 11,519                     | 11,519                         | -                       |
| State and political subdivision loans | -             | -             | -                     | -                 | 74,130                     | 74,130                         | -                       |
| Total                                 | 1,382         | 272           | 2,789                 | 4,443             | 539,312                    | 543,755                        | 763                     |

|                               |       |     |       |       |         |         |  |
|-------------------------------|-------|-----|-------|-------|---------|---------|--|
| Loans considered non-accruing | 81    | 22  | 2,026 | 2,129 | 4,622   | 6,751   |  |
| Loans still accruing          | 1,301 | 250 | 763   | 2,314 | 534,690 | 537,004 |  |
| Total                         | 1,382 | 272 | 2,789 | 4,443 | 539,312 | 543,755 |  |

|                    |     |     |       |       |         |         |     |
|--------------------|-----|-----|-------|-------|---------|---------|-----|
| December 31, 2013  |     |     |       |       |         |         |     |
| Real estate loans: |     |     |       |       |         |         |     |
| Mortgages          | 362 | 40  | 739   | 1,141 | 118,743 | 119,884 | 301 |
| Home Equity        | 632 | 2   | 229   | 863   | 66,354  | 67,217  | 51  |
| Commercial         | 88  | 319 | 3,091 | 3,498 | 189,589 | 193,087 | 344 |
| Agricultural       | -   | -   | -     | -     | 22,001  | 22,001  | -   |
| Construction       | -   | -   | -     | -     | 8,937   | 8,937   | -   |

|                                       |                 |               |                 |                 |                   |                   |            |
|---------------------------------------|-----------------|---------------|-----------------|-----------------|-------------------|-------------------|------------|
| Consumer                              | 96              | 36            | 16              | 148             | 9,415             | 9,563             | 1          |
| Other commercial loans                | 29              | 28            | 49              | 106             | 44,382            | 44,488            | -          |
| Other agricultural loans              | -               | -             | -               | -               | 9,541             | 9,541             | -          |
| State and political subdivision loans | -               | -             | -               | -               | 65,894            | 65,894            | -          |
| <b>Total \$</b>                       | <b>1,207 \$</b> | <b>425 \$</b> | <b>4,124 \$</b> | <b>5,756 \$</b> | <b>534,856 \$</b> | <b>540,612 \$</b> | <b>697</b> |

|                              |                 |               |                 |                 |                   |                |
|------------------------------|-----------------|---------------|-----------------|-----------------|-------------------|----------------|
| Loans considered non-accrual | 98 \$           | 164 \$        | 3,427 \$        | 3,689 \$        | 4,408 \$          | 8,097          |
| Loans still accruing         | 1,109           | 261           | 697             | 2,067           | 530,448           | 532,515        |
| <b>Total \$</b>              | <b>1,207 \$</b> | <b>425 \$</b> | <b>4,124 \$</b> | <b>5,756 \$</b> | <b>534,856 \$</b> | <b>540,612</b> |

#### Nonaccrual Loans

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

The following table reflects the financing receivables on non-accrual status as of September 30, 2014 and December 31, 2013, respectively. The balances are presented by class of financing receivable (in thousands):

|                                 | September 30,<br>2014 | December 31,<br>2013 |
|---------------------------------|-----------------------|----------------------|
| Real estate loans:              |                       |                      |
| Mortgages                       | \$ 734                | \$ 508               |
| Home Equity                     | 179                   | 177                  |
| Commercial                      | 5,003                 | 7,247                |
| Agricultural                    | -                     | -                    |
| Construction                    | -                     | -                    |
| Consumer                        | 50                    | 15                   |
| Other commercial loans          | 785                   | 150                  |
| Other agricultural loans        | -                     | -                    |
| State and political subdivision | -                     | -                    |
|                                 | \$ 6,751              | \$ 8,097             |

#### Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a Troubled Debt Restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to modify more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring by calculating the present value of the revised loan terms and comparing this balance to the Company's investment in the loan prior to the restructuring. As these loans are individually evaluated, they are excluded from pooled portfolios when calculating the allowance for loan and lease losses and a separate allocation within the allowance for loan and lease losses is provided. Management continually evaluates loans that are considered TDRs, including payment history under the modified loan terms, the borrower's ability to continue to repay the loan based on continued evaluation of their operating results and cash flows from operations. Based on this evaluation management would no longer consider a loan to be a TDR when the relevant facts support such a conclusion. As of September 30, 2014 and December 31, 2013, included within the allowance for loan losses are reserves of \$29,000 and \$28,000 respectively, that are associated with loans modified as TDRs.

There were no loan modifications that were considered TDRs during the three months ended September 30, 2014 or 2013. Loan modifications that are considered TDRs completed during the nine months ended September 30, 2014 and 2013 were as follows (dollars in thousands):

|  | For the Nine months Ended September 30, 2014 |  |                               |
|--|--|--|-------------------------------|
|  | Number of contracts                          | Pre-modification Outstanding Recorded Investment | Post-Modification Outstanding |
|  |  |  |                               |

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|                       | Interest<br>Modification | Term<br>Modification | Interest<br>Modification | Term<br>Modification | Recorded Investment<br>Interest<br>Modification | Term<br>Modification |
|-----------------------|--------------------------|----------------------|--------------------------|----------------------|---|----------------------|
| Real estate<br>loans: |                          |                      |                          |                      |   |                      |
| Commercial            | -                        | 2 \$                 | - \$                     | 153 \$               | - \$  | 153                  |
| Total                 | -                        | 2 \$                 | - \$                     | 153 \$               | - \$  | 153                  |

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## For the Nine months Ended September 30, 2013

|                        | Number of contracts   |                   | Pre-modification Outstanding |                   | Post-Modification Outstanding |                   |
|------------------------|-----------------------|-------------------|------------------------------|-------------------|-------------------------------|-------------------|
|                        | Interest Modification | Term Modification | Interest Modification        | Term Modification | Interest Modification         | Term Modification |
| Real estate loans:     |                       |                   |                              |                   |                               |                   |
| Mortgages              | 1                     |                   | \$ 72                        | \$ -              | \$ 72                         | \$ -              |
| Commercial             | -                     | 2                 | -                            | 1,365             | -                             | 1,365             |
| Other commercial loans | -                     | 2                 | -                            | 1,530             | -                             | 1,530             |
| Total                  | 1                     | 4                 | \$ 72                        | \$ 2,895          | \$ 72                         | \$ 2,895          |

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. The following table presents the recorded investment in loans that were modified as TDRs during each 12-month period prior to the current reporting periods, which begin January 1, 2014 and 2013 (nine month periods) and July 1, 2014 and 2013 (3 month periods), respectively, and that subsequently defaulted during these reporting periods (dollars in thousands):

|                    | For the Three Months Ended |                     |                     |                     | For the Nine months Ended |                     |                     |                     |
|--------------------|----------------------------|---------------------|---------------------|---------------------|---------------------------|---------------------|---------------------|---------------------|
|                    | September 30, 2014         |                     | September 30, 2013  |                     | September 30, 2014        |                     | September 30, 2013  |                     |
|                    | Number of contracts        | Recorded investment | Number of contracts | Recorded investment | Number of contracts       | Recorded investment | Number of contracts | Recorded investment |
| Real estate loans: |                            |                     |                     |                     |                           |                     |                     |                     |
| Commercial         | -                          | \$ -                | -                   | \$ -                | 1                         | \$ 483              | -                   | \$ -                |
| Total recidivism   | -                          | \$ -                | -                   | \$ -                | 1                         | \$ 483              | -                   | \$ -                |

## Allowance for Loan Losses

The following table segregates the allowance for loan losses (ALLL) into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of September 30, 2014 and December 31, 2013, respectively (in thousands):

|                             | September 30, 2014                    |                                       |        | December 31, 2013                     |                                       |        |
|-----------------------------|---------------------------------------|---------------------------------------|--------|---------------------------------------|---------------------------------------|--------|
|                             | Individually evaluated for impairment | Collectively evaluated for impairment | Total  | Individually evaluated for impairment | Collectively evaluated for impairment | Total  |
| Real estate loans:          |                                       |                                       |        |                                       |                                       |        |
| Residential                 | \$ 25                                 | \$ 861                                | \$ 886 | \$ 27                                 | \$ 919                                | \$ 946 |
| Commercial and agricultural | 97                                    | 3,606                                 | 3,703  | 305                                   | 4,253                                 | 4,558  |

|   |        |          |          |        |          |          |
|---|--------|----------|----------|--------|----------|----------|
| Construction                                  | -      | 23       | 23       | -      | 50       | 50       |
| Consumer                                      | -      | 86       | 86       | -      | 105      | 105      |
| Other commercial<br>and agricultural<br>loans | 36     | 1,127    | 1,163    | 1      | 941      | 942      |
| State and political<br>subdivision<br>loans   | -      | 450      | 450      | -      | 330      | 330      |
| Unallocated                                   | -      | 505      | 505      | -      | 167      | 167      |
| Total   | \$ 158 | \$ 6,658 | \$ 6,816 | \$ 333 | \$ 6,765 | \$ 7,098 |

The following tables roll forward the balance of the ALLL by portfolio segment for the three and nine month periods ended September 30, 2014 and 2013, respectively (in thousands):



|   | Balance at<br>June 30,<br>2014 | Charge-offs | Recoveries | Provision | Balance at<br>September<br>30, 2014 |
|---|--------------------------------|-------------|------------|-----------|-------------------------------------|
| Real estate loans:                            |                                |             |            |           |                                     |
| Residential                                   | \$ 879                         | \$ -        | \$ -       | \$ 7      | \$ 886                              |
| Commercial and<br>agricultural                | 3,809                          | (11)        | 4          | (99)      | 3,703                               |
| Construction                                  | 13                             | -           | -          | 10        | 23                                  |
| Consumer                                      | 86                             | (26)        | 6          | 20        | 86                                  |
| Other commercial<br>and agricultural<br>loans | 1,151                          | (58)        | -          | 70        | 1,163                               |
| State and political<br>subdivision loans      | 455                            | -           | -          | (5)       | 450                                 |
| Unallocated                                   | 358                            | -           | -          | 147       | 505                                 |
| Total   | \$ 6,751                       | \$ (95)     | \$ 10      | \$ 150    | \$ 6,816                            |

|   | Balance at<br>December<br>31, 2013 | Charge-offs | Recoveries | Provision | Balance at<br>September<br>30, 2014 |
|---|------------------------------------|-------------|------------|-----------|-------------------------------------|
| Real estate loans:                            |                                    |             |            |           |                                     |
| Residential                                   | \$ 946                             | \$ (45)     | \$ -       | \$ (15)   | \$ 886                              |
| Commercial and<br>agricultural                | 4,558                              | (486)       | 9          | (378)     | 3,703                               |
| Construction                                  | 50                                 | -           | -          | (27)      | 23                                  |
| Consumer                                      | 105                                | (40)        | 21         | -         | 86                                  |
| Other commercial<br>and agricultural<br>loans | 942                                | (221)       | -          | 442       | 1,163                               |
| State and political<br>subdivision loans      | 330                                | -           | -          | 120       | 450                                 |
| Unallocated                                   | 167                                | -           | -          | 338       | 505                                 |
| Total   | \$ 7,098                           | \$ (792)    | \$ 30      | \$ 480    | \$ 6,816                            |

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

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|             |          |         |      |       |          |
|-------------|----------|---------|------|-------|----------|
| Unallocated | 343      | -       | -    | (144) | 199      |
| Total       | \$ 6,989 | \$ (15) | \$ 6 | \$ 90 | \$ 7,070 |

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

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

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

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

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

We continually review the model utilized in calculating the required allowance. The following qualitative factors experienced changes during the first nine months of 2014:

- The qualitative factor for national, state, regional and local economic trends and business conditions was decreased for all loan categories due to a decrease in the unemployment rates in the local and state economy.
- The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were decreased for commercial and agricultural real estate due to the decrease in the Company's classified loans to its lowest level in three years and a decrease in the amount of loans past due.

- The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were increased for other commercial loans due to an increase in classified loans during 2014.
- The qualitative factor for levels of and trends in charge-offs and recoveries was increased for commercial real estate and other commercial loans due to the increase in charge-offs compared to historical norms for the Bank.
- The qualitative factor for experience, ability and depth of lending management and other relevant staff was decreased for all loan categories due to the length of time employees involved throughout the loan process have been in their positions.
- The qualitative factor for industry conditions, including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses was decreased for agricultural related loans due to the improvement in the agricultural economy during 2014.

The following qualitative factors experienced changes during the three months ended September 30, 2014:

- The qualitative factor for levels of and trends in charge-offs and recoveries was increased for commercial real estate and other commercial loans due to the increase in charge-offs compared to historical norms for the Bank.
- The qualitative factors for changes in levels of and trends in delinquencies, impaired/classified loans were decreased for other commercial loans real estate due to the decrease in the amount of loans past due as of September 30, 2014.
- The qualitative factor for industry conditions, including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses was decreased for agricultural related loans due to the improvement in the agricultural economy during 2014.

The primary factor that resulted in negative provisions for certain portfolio segments for the three and nine month periods is due to decreases in the outstanding balances for certain portfolio segments compared to December 31, 2013, a reduction in the amount of substandard loans and the decrease in the qualitative factor associated with the improvement in unemployment rates noted above.

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

- The qualitative factor for national, state, regional and local economic trends and business conditions was increased for all loan categories due to rising unemployment rates in the local economy as a result of the slowdown in Marcellus shale natural gas exploration activities.
- The qualitative factor for trends in volume, terms and nature of the loan portfolio was increased for commercial and agricultural real estate, other commercial and agricultural loans and state and political subdivision loan categories due to the increase of the number of loans that are participations that were purchased from other banks and therefore subject to different underwriting standards.
- The qualitative factor for the existence and effect of any credit concentrations and changes in the level of such concentrations was increased for other commercial and agricultural loans and was lowered for commercial and agricultural real estate as the loan growth has slowed in 2013.

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

#### Note 6 – Federal Home Loan Bank Stock

The Bank is a member of the FHLB of Pittsburgh and as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. As of September 30, 2014 and December 31, 2013, the Bank holds \$2,656,400 and \$3,652,100, respectively. The stock is bought from and sold to the FHLB based upon its \$100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated by management. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) A significant decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB's regulatory capital ratios have

improved, liquidity appears adequate, new shares of FHLB stock continue to exchange hands at the \$100 par value and the FHLB has repurchased shares of excess capital stock from its members and has pays a quarterly cash dividend.

## Note 7 - Employee Benefit Plans

For additional detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 11 of the Company's Consolidated Financial Statements included in the 2013 Annual Report on Form 10-K.

## Noncontributory Defined Benefit Pension Plan

The Bank sponsors a noncontributory defined benefit pension plan ("Pension Plan") covering substantially all employees and officers. The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plan's actuary. Any employee with a hire date of January 1, 2007 or later is not eligible to participate in the Pension Plan. In lieu of the Pension Plan, employees with a hire date of January 1, 2007 or later are eligible to receive, after meeting certain length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

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

The following sets forth the components of net periodic benefit costs of the Pension Plan for the three and nine months ended September 30, 2014 and 2013, respectively (in thousands):

|  | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|-------|------------------------------------|--------|
|  | 2014                                | 2013  | 2014                               | 2013   |
| Service cost                             | \$ 77                               | \$ 81 | \$ 230                             | \$ 258 |
| Interest cost                            | 104                                 | 89    | 311                                | 274    |
| Expected<br>return on<br>plan assets     | (197)                               | (165) | (590)                              | (508)  |
| Net<br>amortization<br>and deferral      | 13                                  | 66    | 38                                 | 194    |
| Net periodic<br>benefit cost<br>(return) | \$ (3)                              | \$ 71 | \$ (11)                            | \$ 218 |

The Company contributed \$300,000 to the Pension Plan in 2014.

## Defined Contribution Plan

The Company sponsors a voluntary 401(k) savings plan which eligible employees can elect to contribute up to the maximum amount allowable not to exceed the limits of IRS Code Sections 401(k). Under the plan, the Company also makes required contributions on behalf of the eligible employees. The Company's contributions vest immediately. Contributions by the Company totaled \$201,000 and \$193,000 for the nine months ended September 30, 2014 and 2013, respectively. For the three months ended September 30, 2014 and 2013, contributions by the Company totaled \$55,000 and \$45,000, respectively.

Directors' Deferred Compensation Plan

The Company's directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. At September 30, 2014 and December 31, 2013, an obligation of \$963,000 and \$981,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Amounts included in interest expense on the deferred amounts totaled \$4,000 and \$5,000 for each of the three months ended September 30, 2014 and 2013. For the nine months ended September 30, 2014 and 2013, amounts included in interest expense on the deferred amounts totaled \$15,000 and \$12,000, respectively.



## Restricted Stock Plan

The Company maintains a Restricted Stock Plan (the “Plan”) whereby employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company’s common stock and are subject to certain vesting requirements including continuous employment or service with the Company. A total of 100,000 shares of the Company’s common stock have been authorized under the Plan. As of September 30, 2014, 64,158 shares remain available to be issued under the Plan. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

The following table details the vesting, awarding and forfeiting of restricted shares during 2014 and 2013:

|                                  | Three months ended September 30, |                               |          |                               | Nine months ended September 30, |                               |          |                               |
|----------------------------------|----------------------------------|-------------------------------|----------|-------------------------------|---------------------------------|-------------------------------|----------|-------------------------------|
|                                  | 2014                             |                               | 2013     |                               | 2014                            |                               | 2013     |                               |
|                                  | Unvested                         | Weighted Average Market Price | Unvested | Weighted Average Market Price | Unvested                        | Weighted Average Market Price | Unvested | Weighted Average Market Price |
|                                  | Shares                           | Market Price                  | Shares   | Price                         | Shares                          | Market Price                  | Shares   | Price                         |
| Outstanding, beginning of period | 7,187                            | \$ 48.28                      | 7,466    | \$ 41.89                      | 7,172                           | \$ 42.02                      | 8,646    | \$ 35.51                      |
| Granted                          | -                                | -                             | -        | -                             | 3,598                           | 52.82                         | 3,027    | 48.21                         |
| Forfeited                        | (7)                              | 37.10                         | -        | -                             | (7)                             | 37.10                         | (55)     | 37.10                         |
| Vested                           | -                                | -                             | -        | -                             | (3,583)                         | 40.30                         | (4,152)  | 33.26                         |
| Outstanding, end of period       | 7,180                            | \$ 48.29                      | 7,466    | \$ 41.89                      | 7,180                           | \$ 48.29                      | 7,466    | \$ 41.89                      |

Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. Compensation expense related to restricted stock was \$115,000 and \$117,000 for the nine months ended September 30, 2014 and 2013, respectively. For the three months ended September 30, 2014 and 2013, compensation expense totaled \$42,000 and \$39,000, respectively.

## Supplemental Executive Retirement Plan

The Company maintains a non-qualified supplemental executive retirement plan (“SERP”) for certain executives to compensate those executive participants in the Company’s noncontributory defined benefit pension plan whose benefits are limited by compensation limitations under current tax law. At September 30, 2014 and December 31, 2013, an obligation of \$1,160,000 and \$1,046,000, respectively, was included in other liabilities for this plan in the Consolidated Balance Sheet. Expenses related to this plan totaled \$114,000 and \$109,000 for the nine months ended September 30, 2014 and 2013, respectively. For the three months ended September 30, 2014 and 2013, expenses totaled \$38,000 and \$37,000, respectively.

## Note 8 – Accumulated Comprehensive Income

The following tables present the changes in accumulated other comprehensive (loss) income by component net of tax for the three and nine months ended September 30, 2014 and 2013 (in thousands):



| Three months ended September 30, 2014  |  |  |                                      |          |
|--|--|--|--------------------------------------|----------|
|  | Unrealized gain<br>(loss) on available<br>for sale<br>securities (a) | Unrealized gain<br>(loss) on interest<br>rate swap (a) | Defined Benefit<br>Pension Items (a) | Total    |
| Balance as of<br>June 30, 2014   | \$ 2,201   | \$ -   | \$ (1,101)                           | \$ 1,100 |
| Other<br>comprehensive<br>income before<br>reclassifications<br>(net of tax)                           | 564  | -  | -                                    | 564      |
| Amounts<br>reclassified from<br>accumulated<br>other<br>comprehensive<br>income (loss) (net<br>of tax) | (160)  | -  | 9                                    | (151)    |
| Net current<br>period other<br>comprehensive<br>income   | 404  | -  | 9                                    | 413      |
| Balance as of<br>September 30,<br>2014   | \$ 2,605   | \$ -   | \$ (1,092)                           | \$ 1,513 |

| Nine months ended September 30, 2014   |  |  |                                      |            |
|--|--|--|--------------------------------------|------------|
|  | Unrealized gain<br>(loss) on available<br>for sale<br>securities (a) | Unrealized gain<br>(loss) on interest<br>rate swap (a) | Defined Benefit<br>Pension Items (a) | Total      |
| Balance as of<br>December 31,<br>2013  | \$ (108)   | \$ -   | \$ (1,117)                           | \$ (1,225) |
| Other<br>comprehensive<br>income before<br>reclassifications<br>(net of tax)                           | 3,035  | -  | -                                    | 3,035      |
| Amounts<br>reclassified from<br>accumulated<br>other<br>comprehensive<br>income (loss) (net<br>of tax) | (322)  | -  | 25                                   | (297)      |
|  | 2,713  | -  | 25                                   | 2,738      |

Net current  
period other  
comprehensive  
income

|  |    |       |    |   |    |         |    |       |
|--|----|-------|----|---|----|---------|----|-------|
| Balance as of<br>September 30,<br>2014 | \$ | 2,605 | \$ | - | \$ | (1,092) | \$ | 1,513 |
|--|----|-------|----|---|----|---------|----|-------|

Three months ended September 30, 2013

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

Nine months ended September 30, 2013

|  | Unrealized gain<br>(loss) on available<br>for sale<br>securities (a) | Unrealized gain<br>(loss) on interest<br>rate swap (a) | Defined Benefit<br>Pension Items (a) | Total    |
|--|--|--|--------------------------------------|----------|
| Balance as of<br>December 31,<br>2012  | \$ 6,754   | \$ (132)   | \$ (1,991)                           | \$ 4,631 |
| Other<br>comprehensive<br>income (loss)<br>before<br>reclassifications<br>(net of tax) | (5,422)  | 102  | -                                    | (5,320)  |

Amounts  
reclassified from  
accumulated  
other

|   |          |         |            |          |
|---|----------|---------|------------|----------|
| comprehensive<br>income (loss) (net<br>of tax)                | (255)    | -       | 128        | (127)    |
| Net current<br>period other<br>comprehensive<br>income (loss) | (5,677)  | 102     | 128        | (5,447)  |
| Balance as of<br>September 30,<br>2013                        | \$ 1,077 | \$ (30) | \$ (1,863) | \$ (816) |

(a) Amounts in  
parentheses  
indicate debits

The following table presents the significant amounts reclassified out of each component of accumulated other comprehensive income for the three and nine months ended September 30, 2014 and 2013 (in thousands):

| Details about accumulated<br>other comprehensive income<br>(loss) | Amount reclassified from accumulated<br>comprehensive income (loss) (a)<br>Three Months Ended |                       | Affected line item in<br>the statement where<br>net Income is<br>presented |
|---|---|-----------------------|--|
|   | September 30,<br>2014   | September 30,<br>2013 |  |
| Unrealized gains and losses<br>on available for sale securities   |   |                       |  |
|   | \$ 242  | \$ 91                 | Investment securities gains, net   |
|   | (82)  | (30)                  | Provision for income taxes   |
|   | \$ 160  | \$ 61                 | Net of tax   |
| Defined benefit pension items                                     |   |                       |  |
|   | \$ (13)   | \$ (66)               | Salaries and employee benefits   |
|   | 4   | 22                    | Provision for income taxes   |
|   | \$ (9)  | \$ (44)               | Net of tax   |
| Total reclassifications   | \$ 151  | \$ 17                 |  |
|   |   |                       |  |
|   | Nine Months Ended   |                       |  |
|   | September 30,<br>2014   | September 30,<br>2013 |  |
| Unrealized gains and losses<br>on available for sale securities   |   |                       |  |
|   | \$ 488  | \$ 385                | Investment securities gains, net   |
|   | (166)   | (130)                 | Provision for income taxes   |
|   | \$ 322  | \$ 255                | Net of tax   |
| Defined benefit pension items                                     |   |                       |  |
|   | \$ (38)   | \$ (194)              | Salaries and employee benefits   |
|   | 13  | 66                    | Provision for income taxes   |
|   | \$ (25)   | \$ (128)              | Net of tax   |
| Total reclassifications   | \$ 297  | \$ 127                |  |

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

#### Note 9 – Fair Value Measurements

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

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

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

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

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

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

#### Financial Instruments Recorded at Fair Value on a Recurring Basis

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

The following tables present the assets and liabilities reported on the consolidated balance sheet at their fair value on a recurring basis as of September 30, 2014 and December 31, 2013 by level within the fair value hierarchy (in thousands). Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| September 30, 2014  | Level I | Level II   | Level III | Total      |
|---|---------|------------|-----------|------------|
| Fair value measurements on a recurring basis:               |         |            |           |            |
| Assets  |         |            |           |            |
| Securities available for sale:                              |         |            |           |            |
| U.S. agency securities                                      | \$ -    | \$ 146,485 | \$ -      | \$ 146,485 |
| U.S. treasury securities                                    | -       | 11,530     | -         | 11,530     |
| Obligations of state and political subdivisions             | -       | 100,423    | -         | 100,423    |
| Corporate obligations                                       | -       | 14,100     | -         | 14,100     |
| Mortgage-backed securities in government sponsored entities | -       | 33,982     | -         | 33,982     |
|   | 1,763   | -          | -         | 1,763      |



Equity securities  
in financial  
institutions

December 31, 2013

Fair value  
measurements on a  
recurring basis:

Securities available  
for sale:

|                        |    |   |    |         |    |   |    |         |
|------------------------|----|---|----|---------|----|---|----|---------|
| U.S. agency securities | \$ | - | \$ | 152,189 | \$ | - | \$ | 152,189 |
|------------------------|----|---|----|---------|----|---|----|---------|

|                            |  |   |  |        |  |   |  |        |
|----------------------------|--|---|--|--------|--|---|--|--------|
| U.S. treasuries securities |  | - |  | 11,309 |  | - |  | 11,309 |
|----------------------------|--|---|--|--------|--|---|--|--------|

|   |  |   |  |        |  |   |  |        |
|---|--|---|--|--------|--|---|--|--------|
| Obligations of state and political subdivisions |  | - |  | 95,005 |  | - |  | 95,005 |
|---|--|---|--|--------|--|---|--|--------|

|                       |  |   |  |        |  |   |  |        |
|-----------------------|--|---|--|--------|--|---|--|--------|
| Corporate obligations |  | - |  | 16,802 |  | - |  | 16,802 |
|-----------------------|--|---|--|--------|--|---|--|--------|

|   |  |   |  |        |  |   |  |        |
|---|--|---|--|--------|--|---|--|--------|
| Mortgage-backed securities in government sponsored entities |  | - |  | 40,671 |  | - |  | 40,671 |
|---|--|---|--|--------|--|---|--|--------|

|   |  |       |  |   |  |   |  |       |
|---|--|-------|--|---|--|---|--|-------|
| Equity securities in financial institutions |  | 1,325 |  | - |  | - |  | 1,325 |
|---|--|-------|--|---|--|---|--|-------|

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

The Company may be required, from time to time, to measure certain financial assets, financial liabilities, non-financial assets and non-financial liabilities at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market value that were recognized at fair value below cost at the end of the period. Certain non-financial assets measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. Non-financial assets measured at fair value on a non-recurring basis during 2014 and 2013 include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for possible loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense.

- Impaired Loans - Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Collateral values are estimated using Level 2 inputs based on observable market data and Level 3 inputs based on customized discounting criteria. For a majority of impaired real estate related loans, the Company obtains a current external appraisal. Other valuation techniques are used as well, including internal valuations, comparable property analysis and contractual sales information.
- Other Real Estate owned – Other real estate owned, which is obtained through the Bank’s foreclosure process is valued utilizing the appraised collateral value. Collateral values are estimated using Level 2 inputs based on observable market data and Level III inputs based on customized discounting criteria. At the time the foreclosure is completed, the Company obtains an updated external appraisal.

Assets measured at fair value on a nonrecurring basis as of September 30, 2014 and December 31, 2013 are included in the table below (in thousands):

| September<br>30, 2014         | Level I | Level II | Level III | Total     |
|-------------------------------|---------|----------|-----------|-----------|
| Impaired<br>Loans             | \$ -    | \$ -     | \$ 8,441  | \$ 8,441  |
| Other real<br>estate<br>owned | -       | -        | 1,564     | 1,564     |
| December<br>31, 2013          |         |          |           |           |
| Impaired<br>Loans             | \$ -    | \$ -     | \$ 10,067 | \$ 10,067 |
| Other real<br>estate<br>owned | -       | -        | 1,360     | 1,360     |

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

| Fair Value at<br>September 30,<br>2014 |        | Valuation<br>Technique(s)         | Unobservable<br>input                | Range            |
|--|--------|-----------------------------------|--------------------------------------|------------------|
| Impaired Loans                         | \$ 241 | Discounted<br>Cash Flows          | Probability of<br>Default            | 0%               |
|  |        |                                   | Change in interest<br>rates          | 0-7%             |
|  |        | Appraised<br>Collateral<br>Values | Discount for time<br>since appraisal | 0-60%            |
|  | 8,200  |                                   | Selling costs                        | 4%-10%           |
|  |        |                                   | Holding period                       | 0 - 18<br>months |
| Other real estate<br>owned             | 1,564  | Appraised<br>Collateral<br>Values | Discount for time<br>since appraisal | 0-30%            |
|  |        |                                   | Selling costs                        | 4%-10%           |
|  |        |                                   | Holding period                       | 0 - 18<br>months |

| Fair Value at<br>December 31,<br>2013 |        | Valuation<br>Technique(s)         | Unobservable<br>input                | Range            |
|---------------------------------------|--------|-----------------------------------|--------------------------------------|------------------|
| Impaired Loans                        | \$ 263 | Discounted<br>Cash Flows          | Probability of<br>Default            | 0%               |
|                                       |        |                                   | Change in interest<br>rates          | 0-7%             |
|                                       | 9,804  | Appraised<br>Collateral<br>Values | Discount for time<br>since appraisal | 0-30%            |
|                                       |        |                                   | Selling costs                        | 4%-10%           |
|                                       |        |                                   | Holding period                       | 0 - 18<br>months |
| Other real estate<br>owned            | 1,360  | Appraised<br>Collateral<br>Values | Discount for time<br>since appraisal | 0-20%            |
|                                       |        |                                   | Selling costs                        | 4%-10%           |
|                                       |        |                                   | Holding period                       | 0 - 18<br>months |

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

| September 30, 2014                                    | Carrying   |            |            |          |            |
|---|------------|------------|------------|----------|------------|
|   | Amount     | Fair Value | Level I    | Level II | Level III  |
| Financial assets:                                     |            |            |            |          |            |
| Cash and due from<br>banks                            | \$ 11,323  | \$ 11,323  | \$ 11,323  | \$ -     | \$ -       |
| Interest bearing time<br>deposits with other<br>banks | 5,712      | 5,721      |            | 5,721    |            |
| Available-for-sale<br>securities                      | 308,283    | 308,283    | 1,763      | 306,520  |            |
| Loans held for sale                                   | 753        | 753        | 753        |          |            |
| Net loans   | 536,939    | 552,458    | -          | -        | 552,458    |
| Bank owned life<br>insurance                          | 15,045     | 15,045     | 15,045     | -        | -          |
| Regulatory stock                                      | 2,930      | 2,930      | 2,930      | -        | -          |
| Accrued interest<br>receivable                        | 3,689      | 3,689      | 3,689      | -        | -          |
| Financial liabilities:                                |            |            |            |          |            |
| Deposits  | \$ 768,042 | \$ 768,624 | \$ 514,468 | \$ -     | \$ 254,156 |
| Borrowed funds  | 37,729     | 34,363     | -          | 34,363   | -          |
| Accrued interest payable                              | 753        | 753        | 753        | -        | -          |

December 31, 2013

## Financial assets:

|   |            |            |            |         |            |
|---|------------|------------|------------|---------|------------|
| Cash and due from banks                         | \$ 10,083  | \$ 10,083  | \$ 10,083  | \$ -    | \$ -       |
| Interest bearing time deposits with other banks | 2,480      | 2,474      | -          | -       | 2,474      |
| Available-for-sale securities                   | 317,301    | 317,301    | 1,325      | 315,976 | -          |
| Loans held for sale                             | 278        | 278        | 278        | -       | -          |
| Net loans                                       | 533,514    | 547,405    | -          | -       | 547,405    |
| Bank owned life insurance                       | 14,679     | 14,679     | 14,679     | -       | -          |
| Regulatory stock                                | 3,926      | 3,926      | 3,926      | -       | -          |
| Accrued interest receivable                     | 3,728      | 3,728      | 3,728      | -       | -          |
| Financial liabilities:                          |            |            |            |         |            |
| Deposits  | \$ 748,316 | \$ 750,172 | \$ 481,957 | \$ -    | \$ 268,215 |
| Borrowed funds                                  | 66,932     | 63,500     | -          | 63,500  | -          |
| Accrued interest payable                        | 895        | 895        | 895        | -       | -          |

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

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

**Cash and Cash Equivalents:**

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

**Accrued Interest Receivable and Payable:**

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

**Interest bearing time deposits with other banks:**

The fair value of interest bearing time deposits with other banks is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

**Available-For-Sale Securities:**

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

**Loans held for sale**

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

**Loans:**

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

**Bank Owned Life Insurance:**

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

**Regulatory Stock:**

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

Deposits:

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

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

Borrowed Funds:

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

Note 10 – Commitments

The Company has entered into agreements for the construction of a new branch totaling \$1.0 million as of September 30, 2014. Construction started late in the second quarter of 2014.

Note 11 – Recent Accounting Pronouncements

In January 2014, FASB issued ASU 2014-01, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In January 2014, the FASB issued ASU 2014-04, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this Update using either a



modified retrospective transition method or a prospective transition method. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The Company is evaluating the effect of adopting this new accounting Update.

In June 2014, the FASB issued ASU 2014-10, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. The amendments in this Update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. For repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The amendments also require enhanced disclosures. The accounting changes in this Update are effective for the first interim or annual period beginning after December 15, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application is prohibited. The disclosure for certain transactions accounted for as a sale is required to be presented for interim and annual periods beginning after December 15, 2014, and the disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. The disclosures are not required to be presented for comparative periods before the effective date. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In June 2014, the FASB issued ASU 2014-12, Compensation-Stock Compensation (Topic 718): Accounting for Share-Based Payments when the Terms of an Award Provide that a Performance Target Could Be Achieved After the Requisite Service Period. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this Update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying this Update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In August 2014, the FASB issued ASU 2014-14, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40). The amendments in this Update require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. This Update is not expected to have a significant impact on the Company's financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements -Going Concern (Subtopic 205-40). The amendments in this Update provide guidance in accounting principles generally accepted in the United States of America about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. This Update is not expected to have a significant impact on the Company's financial statements.



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

### Forward-Looking Statements

We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of Citizens Financial Services, Inc., First Citizens Community Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use words such as “believes,” “expects,” “anticipates,” or similar expressions, we are making forward-looking statements. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements. The Company would like to caution readers that the following important factors, among others, could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement:

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

Additional factors that may affect our results are discussed under “Part II – Item 1A – Risk Factors” in this report and in the Company's 2013 Annual Report on Form 10-K under “Item 1.A/ Risk Factors.” Except as required by applicable law and regulation, we assume no obligation to update or revise any forward-looking statements after the date on which they are made.

### Introduction

The following is management's discussion and analysis of the financial condition and results of operations presented in the accompanying consolidated financial statements for the Company. Our Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results you may expect for the full year.

The Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our main office in Mansfield, Pennsylvania. Presently we operate 20 banking facilities, 17 of which operate as bank branches. In Pennsylvania, we have branch offices located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Wellsboro Weis Market store and the Mansfield Wal-Mart Super Center. We also have loan production offices in Lock Haven and Dallas, Pennsylvania. In New York, we have a branch office in Wellsville, Allegany County. We have started construction on a full service branch in the Lock Haven market, which will replace the loan production office currently located there, when completed.

### Risk Management

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

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

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

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

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

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

### Competition

The banking industry in the Bank's service area continues to be extremely competitive, both among commercial banks and with financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions and internet entities. The increased competition has resulted from changes in the legal and regulatory guidelines as well as from economic conditions, specifically, the additional wealth resulting from

the exploration of natural gas in our primary market and the limited loan growth opportunities in our primary market and surrounding areas. Mortgage banking firms, financial companies, financial affiliates of industrial companies, brokerage firms, retirement fund management firms and even government agencies provide additional competition for loans and other financial services. The Bank is generally competitive with all competing financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

## Trust and Investment Services; Oil and Gas Services

Our Investment and Trust Services Department offers professional trust administration, investment management services, estate planning and administration, and custody of securities. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Company. Revenues and fees of the Trust Department are reflected in the Company's financial statements. As of September 30, 2014 and December 31, 2013, the Trust Department had \$100.3 and \$99.4 million of assets under management, respectively.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc. The assets associated with these products are not included in the consolidated financial statements since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from \$102.5 million at December 31, 2013 to \$108.7 million at September 30, 2014. Fee income from the sale of these products is reflected in the Company's financial statements as a component of non-interest income in the Consolidated Statement of Income. Management believes that there are opportunities to increase non-interest income through these products and services, and as such, has added additional resources to support this growth.

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 and mineral management. As of September 30, 2014, customers owning approximately 7,800 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

### Overview of the Income Statement

The Company had net income of \$9,909,000 for the first nine months of 2014 compared to \$10,079,000 for last year's comparable period, a decrease of \$170,000 or 1.7%. Basic earnings per share for the first nine months of 2014 were \$3.26, compared to \$3.29 last year, representing a 0.9% decrease. Annualized return on assets and return on equity for the nine months of 2014 were 1.46% and 13.64%, respectively, compared with 1.52% and 15.13% for last year's comparable period.

Net income for the three months ended September 30, 2014 was \$3,368,000 compared to \$3,512,000 in the comparable 2013 period, a decrease of \$144,000 or 4.1%. Basic earnings per share for the three months ended September 30, 2014 were \$1.11, compared to \$1.15 last year, representing a 3.5% decrease. Annualized return on assets and return on equity for the quarter ended September 30, 2014 was 1.48% and 13.59%, respectively, compared with 1.58% and 15.42% for the same 2013 period.

### Net Interest Income

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





Net interest income for the first nine months of 2014 was \$22,736,000, an increase of \$327,000, or 1.5%, compared to the same period in 2013. For the first nine months of 2014, the provision for loan losses totaled \$480,000, an increase of \$165,000 over the comparable period in 2013. Consequently, net interest income after the provision for loan losses was \$22,256,000 compared to \$22,094,000 during the first nine months of 2013.

For the three months ended September 30, 2014, net interest income was \$7,574,000 compared to \$7,745,000, a decrease of \$171,000, or 2.2% over the comparable period in 2013. It should be noted that during the third quarter of 2013, the Bank received a payoff of a non-accrual loan, which resulted in the recognition of \$305,000 of non-accrual interest income. The provision for loan losses this quarter was \$150,000 compared to \$90,000 for last year's third quarter. Consequently, net interest income after the provision for loan losses was \$7,424,000 for the quarter ended September 30, 2014 compared to \$7,655,000 in 2013.

The following table sets forth the average balances of, and the interest earned or incurred on, for each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and interest rate spread created for the nine months and three months ended September 30, 2014 and 2013 on a tax equivalent basis (dollars in thousands):

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

|   | September 30, 2014           |                |                      | September 30, 2013           |                |                      |
|---|------------------------------|----------------|----------------------|------------------------------|----------------|----------------------|
|   | Average<br>Balance (1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% | Average<br>Balance (1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% |
| (dollars in thousands)                      |                              |                |                      |                              |                |                      |
| <b>ASSETS</b>                               |                              |                |                      |                              |                |                      |
| Short-term investments:                     |                              |                |                      |                              |                |                      |
| Interest-bearing deposits at banks          | 8,839                        | 8              | 0.12                 | 18,113                       | 25             | 0.18                 |
| Total short-term investments                | 8,839                        | 8              | 0.12                 | 18,113                       | 25             | 0.18                 |
| Interest bearing time deposits at banks     | 2,900                        | 43             | 2.02                 | 157                          | 2              | 2.02                 |
| Investment securities:                      |                              |                |                      |                              |                |                      |
| Taxable                                     | 215,058                      | 2,701          | 1.67                 | 213,367                      | 2,865          | 1.79                 |
| Tax-exempt (3)                              | 96,653                       | 3,827          | 5.28                 | 92,200                       | 3,883          | 5.62                 |
| Total investment securities                 | 311,711                      | 6,528          | 2.79                 | 305,567                      | 6,748          | 2.94                 |
| Loans:                                      |                              |                |                      |                              |                |                      |
| Residential mortgage loans                  | 187,139                      | 7,950          | 5.68                 | 180,528                      | 8,214          | 6.08                 |
| Construction                                | 5,116                        | 178            | 4.66                 | 13,557                       | 506            | 4.99                 |
| Commercial & agricultural loans             | 269,483                      | 10,963         | 5.44                 | 249,105                      | 11,128         | 5.97                 |
| Loans to state & political subdivisions     | 67,114                       | 2,349          | 4.68                 | 59,394                       | 1,975          | 4.45                 |
| Other loans                                 | 8,738                        | 531            | 8.13                 | 9,861                        | 606            | 8.22                 |
| Loans, net of discount (2)(3)(4)            | 537,590                      | 21,971         | 5.46                 | 512,445                      | 22,429         | 5.85                 |
| Total interest-earning assets               | 861,040                      | 28,550         | 4.43                 | 836,282                      | 29,204         | 4.67                 |
| Cash and due from banks                     | 3,775                        |                |                      | 3,748                        |                |                      |
| Bank premises and equipment                 | 11,271                       |                |                      | 11,432                       |                |                      |
| Other assets                                | 29,283                       |                |                      | 30,448                       |                |                      |
| Total non-interest earning assets           | 44,329                       |                |                      | 45,628                       |                |                      |
| Total assets                                | 905,369                      |                |                      | 881,910                      |                |                      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                              |                |                      |                              |                |                      |
| Interest-bearing liabilities:               |                              |                |                      |                              |                |                      |

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|  |         |        |       |         |        |       |
|--|---------|--------|-------|---------|--------|-------|
| NOW accounts   | 218,557 | 572    | 0.35  | 207,003 | 586    | 0.38  |
| Savings accounts   | 100,619 | 87     | 0.12  | 91,727  | 113    | 0.16  |
| Money market accounts  | 89,595  | 309    | 0.46  | 85,641  | 303    | 0.47  |
| Certificates of deposit  | 259,907 | 2,323  | 1.19  | 272,930 | 2,892  | 1.42  |
| Total interest-bearing deposits  | 668,678 | 3,291  | 0.66  | 657,301 | 3,894  | 0.79  |
| Other borrowed funds   | 40,416  | 451    | 1.49  | 40,391  | 951    | 3.15  |
| Total interest-bearing liabilities                                     | 709,094 | 3,742  | 0.71  | 697,692 | 4,845  | 0.93  |
| Demand deposits  | 92,150  |        |       | 87,379  |        |       |
| Other liabilities  | 7,253   |        |       | 8,039   |        |       |
| Total non-interest-bearing liabilities                                 | 99,403  |        |       | 95,418  |        |       |
| Stockholders' equity   | 96,872  |        |       | 88,800  |        |       |
| Total liabilities & stockholders' equity                               | 905,369 |        |       | 881,910 |        |       |
| Net interest income  |         | 24,808 |       |         | 24,359 |       |
| Net interest spread (5)  |         |        | 3.72% |         |        | 3.74% |
| Net interest income as a percentage of average interest-earning assets |         |        | 3.85% |         |        | 3.89% |
| Ratio of interest-earning assets to interest-bearing liabilities       |         |        | 121%  |         |        | 120%  |

(1) Averages are based on daily averages.

(2) Includes loan origination and commitment fees.

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

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

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



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

|   | September 30, 2014           |                |                      | September 30, 2013           |                |                      |
|---|------------------------------|----------------|----------------------|------------------------------|----------------|----------------------|
|   | Average<br>Balance (1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% | Average<br>Balance (1)<br>\$ | Interest<br>\$ | Average<br>Rate<br>% |
| (dollars in thousands)                      |                              |                |                      |                              |                |                      |
| <b>ASSETS</b>                               |                              |                |                      |                              |                |                      |
| Short-term investments:                     |                              |                |                      |                              |                |                      |
| Interest-bearing deposits at banks          | 15,013                       | 6              | 0.16                 | 14,342                       | 6              | 0.16                 |
| Total short-term investments                | 15,013                       | 6              | 0.16                 | 14,342                       | 6              | 0.16                 |
| Interest bearing time deposits at banks     | 3,725                        | 19             | 2.02                 | 466                          | 2              | 2.02                 |
| Investment securities:                      |                              |                |                      |                              |                |                      |
| Taxable                                     | 206,785                      | 845            | 1.63                 | 217,579                      | 928            | 1.70                 |
| Tax-exempt (3)                              | 98,268                       | 1,278          | 5.20                 | 93,542                       | 1,288          | 5.51                 |
| Total investment securities                 | 305,053                      | 2,123          | 2.78                 | 311,121                      | 2,216          | 2.96                 |
| Loans:                                      |                              |                |                      |                              |                |                      |
| Residential mortgage loans                  | 187,951                      | 2,665          | 5.69                 | 182,457                      | 2,751          | 5.98                 |
| Construction                                | 4,590                        | 56             | 4.86                 | 16,492                       | 201            | 4.85                 |
| Commercial & agricultural loans             | 267,780                      | 3,643          | 5.46                 | 252,580                      | 3,913          | 6.15                 |
| Loans to state & political subdivisions     | 71,450                       | 827            | 4.64                 | 59,778                       | 659            | 4.37                 |
| Other loans                                 | 8,495                        | 172            | 8.14                 | 9,753                        | 201            | 8.17                 |
| Loans, net of discount (2)(3)(4)            | 540,266                      | 7,363          | 5.47                 | 521,060                      | 7,725          | 5.88                 |
| Total interest-earning assets               | 864,057                      | 9,511          | 4.41                 | 846,989                      | 9,949          | 4.66                 |
| Cash and due from banks                     | 3,769                        |                |                      | 3,894                        |                |                      |
| Bank premises and equipment                 | 11,563                       |                |                      | 11,392                       |                |                      |
| Other assets                                | 33,227                       |                |                      | 28,333                       |                |                      |
| Total non-interest earning assets           | 48,559                       |                |                      | 43,619                       |                |                      |
| Total assets                                | 912,616                      |                |                      | 890,608                      |                |                      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                              |                |                      |                              |                |                      |

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|  |         |       |       |         |       |       |
|--|---------|-------|-------|---------|-------|-------|
| Interest-bearing liabilities:  |         |       |       |         |       |       |
| NOW accounts   | 218,615 | 184   | 0.34  | 215,784 | 204   | 0.38  |
| Savings accounts   | 104,897 | 32    | 0.12  | 92,702  | 37    | 0.16  |
| Money market accounts  | 99,466  | 120   | 0.48  | 90,655  | 111   | 0.49  |
| Certificates of deposit  | 255,921 | 756   | 1.18  | 269,978 | 927   | 1.36  |
| Total interest-bearing deposits  | 678,899 | 1,092 | 0.64  | 669,119 | 1,279 | 0.79  |
| Other borrowed funds   | 30,279  | 142   | 1.88  | 34,568  | 283   | 3.25  |
| Total interest-bearing liabilities                                     | 709,178 | 1,234 | 0.70  | 703,687 | 1,562 | 0.88  |
| Demand deposits  | 97,030  |       |       | 89,245  |       |       |
| Other liabilities  | 7,255   |       |       | 6,582   |       |       |
| Total non-interest-bearing liabilities                                 | 104,285 |       |       | 95,827  |       |       |
| Stockholders' equity   | 99,153  |       |       | 91,094  |       |       |
| Total liabilities & stockholders' equity                               | 912,616 |       |       | 890,608 |       |       |
| Net interest income  |         | 8,277 |       |         | 8,387 |       |
| Net interest spread (5)  |         |       | 3.71% |         |       | 3.78% |
| Net interest income as a percentage of average interest-earning assets |         |       | 3.84% |         |       | 3.93% |
| Ratio of interest-earning assets to interest-bearing liabilities       |         |       | 122%  |         |       | 120%  |

(1) Averages are based on daily averages.

(2) Includes loan origination and commitment fees.

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

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

(5) Interest rate spread represents the difference between the average rate earned on interest-earning assets

and the average rate paid on interest-bearing liabilities.





Tax exempt revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 34%. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Company's 34% Federal statutory rate. The following table represents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the periods ending September 30, 2014 and 2013 (in thousands):

|  | For the Three Months<br>Ended September 30 |          | For the Nine Months<br>Ended September 30 |           |
|--|--|----------|---|-----------|
|  | 2014                                       | 2013     | 2014                                      | 2013      |
| Interest and dividend<br>income from investment<br>securities<br>and interest bearing<br>deposits at banks<br>(non-tax adjusted)     | \$ 1,714                                   | \$ 1,786 | \$ 5,278                                  | \$ 5,455  |
| Tax equivalent<br>adjustment   | 434  | 438      | 1,301                                     | 1,320     |
| Interest and dividend<br>income from investment<br>securities<br>and interest bearing<br>deposits at banks (tax<br>equivalent basis) | \$ 2,148                                   | \$ 2,224 | \$ 6,579                                  | \$ 6,775  |
| Interest and fees on<br>loans (non-tax adjusted)   | \$ 7,094                                   | \$ 7,521 | \$ 21,200                                 | \$ 21,799 |
| Tax equivalent<br>adjustment   | 269  | 204      | 771                                       | 630       |
| Interest and fees on<br>loans (tax equivalent<br>basis)  | \$ 7,363                                   | \$ 7,725 | \$ 21,971                                 | \$ 22,429 |
| Total interest income  | \$ 8,808                                   | \$ 9,307 | \$ 26,478                                 | \$ 27,254 |
| Total interest expense   | 1,234                                      | 1,562    | 3,742                                     | 4,845     |
| Net interest income  | 7,574                                      | 7,745    | 22,736                                    | 22,409    |
| Total tax equivalent<br>adjustment   | 703  | 642      | 2,072                                     | 1,950     |
| Net interest income (tax<br>equivalent basis)  | \$ 8,277                                   | \$ 8,387 | \$ 24,808                                 | \$ 24,359 |

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

|                  | Three months ended September 30, 2014<br>vs. 2013 (1) |                   |                 | Nine months ended September 30,<br>2014 vs. 2013 (1) |                   |                 |
|------------------|---|-------------------|-----------------|--|-------------------|-----------------|
|                  | Change in<br>Volume                                   | Change<br>in Rate | Total<br>Change | Change in<br>Volume                                  | Change<br>in Rate | Total<br>Change |
| Interest Income: |   |                   |                 |  |                   |                 |

|   |    |       |    |       |    |         |
|---|----|-------|----|-------|----|---------|
| Short-term investments:                 |    |       |    |       |    |         |
| Interest-bearing deposits at banks      | \$ | -     | \$ | -     | \$ | (17)    |
| Interest bearing time deposits at banks |    | 17    |    | -     |    | 41      |
| Investment securities:                  |    |       |    |       |    |         |
| Taxable                                 |    | (50)  |    | (33)  |    | (164)   |
| Tax-exempt                              |    | 100   |    | (110) |    | (56)    |
| Total investments                       |    | 50    |    | (143) |    | (220)   |
| Loans:                                  |    |       |    |       |    |         |
| Residential mortgage loans              |    | 58    |    | (144) |    | (264)   |
| Construction                            |    | (146) |    | 1     |    | (328)   |
| Commercial & agricultural loans         |    | 221   |    | (491) |    | (165)   |
| Loans to state & political subdivisions |    | 126   |    | 42    |    | 374     |
| Other loans                             |    | (28)  |    | (1)   |    | (75)    |
| Total loans, net of discount            |    | 231   |    | (593) |    | (458)   |
| Total Interest Income                   |    | 298   |    | (736) |    | (654)   |
| Interest Expense:                       |    |       |    |       |    |         |
| Interest-bearing deposits:              |    |       |    |       |    |         |
| NOW accounts                            |    | -     |    | (20)  |    | (14)    |
| Savings accounts                        |    | 6     |    | (11)  |    | (26)    |
| Money Market accounts                   |    | 9     |    | -     |    | 6       |
| Certificates of deposit                 |    | (56)  |    | (115) |    | (569)   |
| Total interest-bearing deposits         |    | (41)  |    | (146) |    | (603)   |
| Other borrowed funds                    |    | (34)  |    | (107) |    | (500)   |
| Total interest expense                  |    | (75)  |    | (253) |    | (1,103) |
| Net interest income                     | \$ | 373   | \$ | (483) | \$ | 449     |

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

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Tax equivalent net interest income increased from \$24,359,000 for the 2013 nine month period ended September 30, 2013 to \$24,808,000 for the 2014 nine month period ended September 30, 2014, an increase of \$449,000. The tax equivalent net interest margin decreased from 3.89% for the first nine months of 2013 to 3.85% in 2014.

Total tax equivalent interest income for the 2014 nine month period decreased \$654,000 as compared to the 2013 nine month period. This decrease was primarily a result of a decrease of \$2,967,000 due to a change in rate, as the yield on interest earning assets decreased from 4.67% to 4.43% or 24 basis points for the comparable periods. This decrease was offset by an increase of \$2,313,000 as a result of an increase in the average balance of interest earning assets of \$24.8 million for the comparable periods. While the Bank has been able to add interest earning assets, the new assets are priced at lower rates than assets that have matured due to the prolonged low interest rate environment. Additionally, assets repriced at lower rates during the 2014 period.

Tax equivalent investment income for the nine months ended September 30, 2014 decreased \$221,000 over the same period last year. The primary cause of this decrease was a decrease in the yield earned on investments of 15 basis points, which caused a decrease in tax equivalent investment income of \$478,000. The average balance of total investment securities for the nine months ended September 30, 2014 increased by \$6.1 million from September 30, 2013, which resulted in additional income of \$257,000.

- The average balance of taxable securities increased by \$1.7 million while tax-exempt securities increased by \$4.5 million, which had the effect of increasing interest income by \$23,000 and \$234,000, respectively, due to volume.
- The yield on taxable securities decreased 12 basis points from 1.79% to 1.67%, which corresponds to a decrease in interest income of \$187,000. The yield on tax-exempt securities decreased 34 basis points, which corresponds to a decrease in interest income of \$291,000. The yield on investments declined due to the amount of purchases we made in the current low interest rate environment. For a discussion of the Company's current investment strategy, see the "Financial Condition – Investments".

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

Total loan interest income decreased \$458,000 for the nine months ended September 30, 2014 compared to the same period last year.

- Interest income on residential mortgage loans decreased \$264,000 primarily as a result of change in rates, which resulted in a decrease of \$590,000. The yield earned on residential loans decreased 40 basis points compared to 2013. This was offset by an increase attributed to volume of \$326,000 as the average balance increased \$6.6 million for the comparable periods.
- Interest income on construction loans decreased \$328,000, primarily due to a change in volume, as the average balance decreased \$8.4 million or 62.3%, as projects were completed and transferred primarily to commercial real estate and state and political subdivision loans.
- The average balance of commercial and agricultural loans increased \$20.4 million from a year ago as we continue to focus on this segment of the loan portfolio, utilizing an experienced lending staff. This had a positive impact of \$1,796,000 on total interest income due to volume, which was offset by a decrease of \$1,961,000 due to rate, as the yield earned decreased from 5.97% to 5.44% due to the continued low rate environment and increased competition.
- The average balance of state and political subdivision loans increased \$7.7 million from a year ago. This had a positive impact of \$266,000 on total interest income due to volume. In addition, the yield earned increased 23 basis

points to 4.68%, which increased loan interest income \$108,000.

Total interest expense decreased \$1,103,000 for the nine months ended September 30, 2014 compared with last year. The decrease is primarily attributable to a change in average rate from .93% in 2013 to .71% in the comparable 2014 period, which had the effect of decreasing interest expense by \$1,035,000. 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 increased \$11.4 million from September 30, 2013 to September 30, 2014. Increases were experienced in NOW accounts of \$11.6 million, savings accounts of \$8.9 million and money market accounts of \$4.0 million. The cumulative effect of these increases was an increase in interest expense of \$64,000. Certificates of deposit decreased \$13.0 million, which resulted in a decrease in interest expense due to volume of \$132,000. (see also "Financial Condition – Deposits").

- Interest expense on certificates of deposits decreased \$569,000 over the same period last year. There was a decrease in the average rate on certificates of deposit from 1.42% to 1.19% resulting in a decrease in interest expense of \$437,000. Additionally, the average balance of certificates of deposit decreased \$13.0 million causing a decrease in interest expense of \$132,000.
- Interest expense on other borrowed funds decreased \$500,000 over the same period last year. The primary cause of the decrease was the average rate on other borrowed funds decreasing 166 basis points resulting in a decrease in interest expense of \$500,000. The decrease in rate on the other borrowed funds is a result of the significant maturities of borrowings in 2013 that were either refinanced long term at a lower rate or that were replaced with overnight borrowings and the maturity of the interest rate swap in the fourth quarter of 2013 that has resulted in a decrease in the interest rate on the trust preferred security.

Tax equivalent net interest income for the three months ended September 30, 2014 was \$8,277,000 which compares to \$8,387,000 for the same period last year. This represents a decrease of \$110,000 or 1.3%.

Total tax equivalent interest income was \$9,511,000 for the 2014 three month period ended September 30, 2014, compared with \$9,949,000 for the comparable period last year, a decrease of \$438,000. Of this amount, \$736,000 was a result of a decrease of 25 basis points on our yield on interest earning assets from 4.66% to 4.41%:

- Total investment income decreased by \$93,000 compared to same period last year. This was due to an 18 point decrease in rate on investments from 2.96% to 2.78%, which equates to \$143,000 decrease in income. This was offset by an increase in income of \$50,000 as a result of a \$4.7 million increase in tax-exempt securities.
- Total loan interest income decreased \$362,000 compared to last year. This was predominantly due to a change in rate of 41 points from 5.88% to 5.47%, which corresponds to a \$593,000 decrease in interest income. This was offset by an increase in volume of \$231,000 as a result of a \$19.2 million increase in average loans outstanding. During the 2013 quarter, the Bank received \$305,000 of non-accrual interest income, which had a positive impact on the quarterly yield for 2013.

Total interest expense decreased \$328,000 for the three months ended September 30, 2014 compared with last year as a result of a decrease in the average rate on interest-bearing liabilities of 18 basis points from 0.88% to 0.70% accounting for a \$253,000 decrease in interest expense. Additionally, due to a \$14.1 million decrease in the average balance of certificates of deposit, there was a \$56,000 decrease in interest expense.

#### Provision for Loan Losses

For the nine month period ending September 30, 2014, we recorded a provision for loan losses of \$480,000, which represents an increase of \$165,000 from the \$315,000 provision recorded in the corresponding nine months of last year. The provision was higher in 2014 than 2013 primarily due to the increase in loan charge-offs in the first nine months of 2014. see “Financial Condition – Allowance for Loan Losses and Credit Quality Risk”).

For the three months ending September 30, 2014, we recorded a provision of \$150,000 compared to \$90,000 in 2013.

#### Non-interest Income

The following table shows the breakdown of non-interest income for the three and nine months ended September 30, 2014 and 2013 (in thousands):

|                                       | Nine months ended September 30, |          | Change |        |
|---------------------------------------|---------------------------------|----------|--------|--------|
|                                       | 2014                            | 2013     | Amount | %      |
| Service charges                       | \$ 3,239                        | \$ 3,313 | \$(74) | (2.2)  |
| Trust                                 | 528                             | 539      | (11)   | (2.0)  |
| Brokerage and insurance               | 398                             | 333      | 65     | 19.5   |
| Gains on loans sold                   | 110                             | 236      | (126)  | (53.4) |
| Investment securities gains, net      | 488                             | 385      | 103    | 26.8   |
| Earnings on bank owned life insurance | 366                             | 377      | (11)   | (2.9)  |
| Other                                 | 337                             | 328      | 9      | 2.7    |
| Total                                 | \$ 5,466                        | \$ 5,511 | \$(45) | (0.8)  |

|                                       | Three months ended September 30, |          | Change |        |
|---------------------------------------|----------------------------------|----------|--------|--------|
|                                       | 2014                             | 2013     | Amount | %      |
| Service charges                       | \$ 1,098                         | \$ 1,145 | \$(47) | (4.1)  |
| Trust                                 | 151                              | 169      | (18)   | (10.7) |
| Brokerage and insurance               | 141                              | 120      | 21     | 17.5   |
| Gains on loans sold                   | 40                               | 75       | (35)   | (46.7) |
| Investment securities gains, net      | 242                              | 91       | 151    | 165.9  |
| Earnings on bank owned life insurance | 124                              | 127      | (3)    | (2.4)  |
| Other                                 | 128                              | 124      | 4      | 3.2    |
| Total                                 | \$ 1,924                         | \$ 1,851 | \$ 73  | 3.9    |



Non-interest income for the nine months ended September 30, 2014 totaled \$5,466,000, a decrease of \$45,000 when compared to the same period in 2013. During the first nine months of 2014, investment security gains amounted to \$488,000 compared to gains of \$385,000 last year. We sold seven agency securities for gains totaling \$137,000, three mortgage backed securities in government sponsored entities for gains totaling \$78,000, and a portion of a financial institution equity holding for a gain of \$101,000 due to favorable market conditions. We also sold one municipal bond for a gain totaling \$172,000 based on a review of the security and its market value. In 2013, we sold eight mortgage backed securities that were repaying quickly for a net gain of \$104,000, four municipal securities for gains totaling \$87,000, four agency securities for gains totaling \$46,000 that were maturing later in 2013, portions of three financial institution equity holdings for gains totaling \$145,000 and a corporate obligation for a gain of \$2,000.

Gains on loans sold decreased \$126,000, or 53.4% for the nine months ended September 30, 2014 to \$110,000. The decrease is due to the significant refinancing activity of secondary market loans that occurred as a result of the low interest rate environment in place in 2013, which has resulted in fewer loans being refinanced in 2014. This slowdown in secondary market loans is not limited to our primary market, but is occurring across numerous markets throughout the United States. During the first nine months of 2014, the Company received proceeds of \$8.1 million from the sale of conforming loans compared to \$17.0 million of proceeds for the comparable 2013 period.

The increase in brokerage and insurance revenues of \$65,000 for the nine months ended September 30, 2014 compared to the 2013 period is the result of hiring additional brokers in the first part of 2014.

For the three month period ended September 30, 2014, the decrease experienced in gains on loans sold are consistent with the year to date decreases described above. The increase in brokerage revenue in the third quarter is consistent with the increase for the year. The increase in investment security gains for the 2014 quarter was due to the sale of the municipal security, which occurred based on a review of the security and its market value.

#### Non-interest Expense

The following tables reflect the breakdown of non-interest expense for the three and nine months ended September 30, 2014 and 2013 (in thousands):

|                                      | Nine months ended |                       | Change<br>Amount | %      |
|--------------------------------------|-------------------|-----------------------|------------------|--------|
|                                      | 2014              | September 30,<br>2013 |                  |        |
| Salaries and<br>employee<br>benefits | \$ 8,600          | \$ 8,456              | \$ 144           | 1.7    |
| Occupancy                            | 967               | 956                   | 11               | 1.2    |
| Furniture<br>and<br>equipment        | 280               | 372                   | (92)             | (24.7) |
| Professional<br>fees                 | 731               | 604                   | 127              | 21.0   |
| FDIC<br>insurance                    | 345               | 337                   | 8                | 2.4    |
| Pennsylvania<br>shares tax           | 485               | 548                   | (63)             | (11.5) |
| Other                                | 3,750             | 3,411                 | 339              | 9.9    |
| Total                                | \$ 15,158         | \$ 14,684             | \$ 474           | 3.2    |

|                                      | Three months ended |                       | Change<br>Amount | %      |
|--------------------------------------|--------------------|-----------------------|------------------|--------|
|                                      | 2014               | September 30,<br>2013 |                  |        |
| Salaries and<br>employee<br>benefits | \$ 2,790           | \$ 2,856              | \$ (66)          | (2.3)  |
| Occupancy                            | 313                | 302                   | 11               | 3.6    |
| Furniture<br>and<br>equipment        | 86                 | 157                   | (71)             | (45.2) |
| Professional<br>fees                 | 289                | 187                   | 102              | 54.5   |
| FDIC<br>insurance                    | 116                | 112                   | 4                | 3.6    |
| Pennsylvania<br>shares tax           | 101                | 183                   | (82)             | (44.8) |
| Other                                | 1,372              | 1,168                 | 204              | 17.5   |

|       |    |       |    |       |    |     |  |     |
|-------|----|-------|----|-------|----|-----|--|-----|
| Total | \$ | 5,067 | \$ | 4,965 | \$ | 102 |  | 2.1 |
|-------|----|-------|----|-------|----|-----|--|-----|

Non-interest expenses increased \$474,000 for the nine months ended September 30, 2014 compared to the same period in 2013. Salaries and employee benefits increased \$144,000 or 1.7%. Merit increases effective at the beginning of 2014 and an increase in full time equivalent employees, as part of implementing the Bank's strategic plan, accounted for an increase in non-interest expenses of approximately \$299,000. Insurance related expenses have decreased \$173,000 as a result of improvements in claims experience.

As a result of purchasing certain non-capitalized equipment for the online teller system in 2013 and certain assets becoming fully depreciated, furniture and equipment expenses decreased \$92,000 or 24.7%. As a result of implementing portions of the Company's strategic plan, professions fees increased \$127,000.

Other expenses increased \$339,000 primarily due to an increase in expenses associated with our other real estate owned properties of approximately \$105,000 and an \$83,000 increase in contributions. A contribution of \$100,000 was made in the third quarter of 2014 compared to the fourth quarter of 2013. It should be noted that as a result of the contributions made in the third quarter, a decrease in the Pennsylvania shares tax occurred as a result of a tax credit program implemented by the State of Pennsylvania. As a result of implementing an online teller system and other parts of the Company's strategic plan, software and subscription expenses increased \$88,000.

For the three months ended, September 30, 2014, non-interest expenses increased \$102,000 when compared to the same period in 2013. Other expenses increased, \$204,000 primarily due to an increase in contributions of \$101,000 as discussed above and an increase in other real estate owned expenses of \$57,000. The increase in professional fees was due to implementing portions of the Company's strategic plan. The decrease in the Pennsylvania shares tax of \$82,000 for the quarter is due the tax credit program mentioned in the previous paragraph. The decrease in furniture and fixtures for the quarter corresponds to the year to date decrease and is a result of purchasing non-capitalized equipment in the third quarter of 2013 for the online teller system. The decrease in salaries and employee benefits is primarily due to a decrease in insurance related costs of \$91,000 offset by merit and headcount increases of \$53,000.

#### Provision for Income Taxes

The provision for income taxes was \$2,655,000 for the nine month period ended September 30, 2014 compared to \$2,842,000 for the same period in 2013. The decrease is primarily attributable to a decrease in income before provision for income taxes of \$357,000. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 21.1% and 22.0% for the first nine months of 2014 and 2013, respectively, compared to the statutory rate of 34%.

For the three months ended September 30, 2014, the provision for income taxes was \$913,000 compared to \$1,029,000 for the same period in 2013. The decrease is primarily attributable to the decrease in income before provision for income taxes of \$260,000. Our effective tax rate was 21.3% and 22.7% for the three months ended September 30, 2014 and 2013, respectively, compared to the statutory rate of 34%.

We have invested in four limited partnership agreements that established low-income housing projects in our market areas. We anticipate recognizing an aggregate of \$1.3 million of tax credits over the next ten years, with an additional \$50,000 to be recognized during 2014.

#### Financial Condition

Total assets were \$913.0 million at September 30, 2014, a decrease of \$1.9 million, or 0.2% from \$914.9 million at December 31, 2013. Cash and cash equivalents increased \$1.2 million or 12.3% to \$11.3 million. Investment securities decreased to \$308.3 million and net loans increased 0.6% to \$536.9 million at September 30, 2014. Total deposits increased \$19.7 million to \$768.0 million since year-end 2013, while borrowed funds decreased \$29.2 million to \$37.7 million.

#### Cash and Cash Equivalents

Cash and cash equivalents totaled \$11.3 million at September 30, 2014 compared to \$10.1 million at December 31, 2013, an increase of \$1.2 million. Management actively measures and evaluates its liquidity through our Asset-Liability Committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources including the Bank's core deposits, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

#### Investments

The following table shows the composition of the investment portfolio as of September 30, 2014 and December 31, 2013 (dollars in thousands):



|   | September 30, 2014 |       | December 31, 2013 |       |
|---|--------------------|-------|-------------------|-------|
|   | Amount             | %     | Amount            | %     |
| Available-for-sale:   |                    |       |                   |       |
| U. S. Agency securities                                     | \$ 146,485         | 47.5  | \$ 152,189        | 48.0  |
| U. S. Treasury notes  | 11,530             | 3.7   | 11,309            | 3.6   |
| Obligations of state & political subdivisions               | 100,423            | 32.6  | 95,005            | 29.9  |
| Corporate obligations                                       | 14,100             | 4.6   | 16,802            | 5.3   |
| Mortgage-backed securities in government sponsored entities | 33,982             | 11.0  | 40,671            | 12.8  |
| Equity securities in financial institutions                 | 1,763              | 0.6   | 1,325             | 0.4   |
| Total   | \$ 308,283         | 100.0 | \$ 317,301        | 100.0 |

|   | September 30, 2014/<br>December 31, 2013<br>Change |        |
|---|--|--------|
|   | Amount   | %      |
| (dollars in thousands)                                      |  |        |
| Available-for-sale:   |  |        |
| U. S. Agency securities                                     | \$ (5,704)   | (3.7)  |
| U. S. Treasury notes  | 221  | 2.0    |
| Obligations of state & political subdivisions               | 5,418  | 5.7    |
| Corporate obligations                                       | (2,702)  | (16.1) |
| Mortgage-backed securities in government sponsored entities | (6,689)  | (16.4) |
| Equity securities in financial institutions                 | 438  | 33.1   |
| Total   | \$ (9,018)   | (2.8)  |

Our investment portfolio decreased by \$9.0 million, or 2.8%, from December 31, 2013 to September 30, 2014. During 2014, we purchased approximately \$34.5 million of U.S. agency obligations, \$9.7 million of state and

local obligations and \$601,000 of equity securities in financial institutions, which helped offset the \$5.2 million of principal repayments and \$34.2 million of calls and maturities that occurred during the nine month period. We also sold \$17.3 million of various securities at a gain of \$488,000. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio for the nine month period ending September 30, 2014 yielded 2.79% compared to 2.94% for the same period in 2013 on a tax equivalent basis.

As a result of the Federal Reserve's continued commitment to a low rate policy, investment yields are significantly below historical levels. The Company's investment strategy in 2014 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 interest 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 and to manage interest rate risk levels.

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

#### Loans

The following table shows the composition of the loan portfolio as of September 30, 2014 and December 31, 2013 (dollars in thousands):

|   | September 30, 2014 |       | December 31, 2013 |       |
|---|--------------------|-------|-------------------|-------|
|   | Amount             | %     | Amount            | %     |
| Real estate:                            |                    |       |                   |       |
| Residential                             | \$ 187,315         | 34.5  | \$ 187,101        | 34.6  |
| Commercial                              | 187,692            | 34.5  | 193,087           | 35.7  |
| Agricultural                            | 24,196             | 4.5   | 22,001            | 4.1   |
| Construction                            | 4,960              | 0.9   | 8,937             | 1.7   |
| Consumer                                | 8,798              | 1.6   | 9,563             | 1.7   |
| Other commercial and agricultural loans | 56,664             | 10.4  | 54,029            | 10.0  |
| State & political subdivision loans     | 74,130             | 13.6  | 65,894            | 12.2  |
| Total loans                             | 543,755            | 100.0 | 540,612           | 100.0 |
| Less allowance for loan losses          | 6,816              |       | 7,098             |       |
| Net loans                               | \$ 536,939         |       | \$ 533,514        |       |

|   | September 30, 2014/<br>December 31, 2013 |        |
|---|--|--------|
|   | Change<br>Amount                         | %      |
| Real estate:                            |  |        |
| Residential                             | \$ 214                                   | 0.1    |
| Commercial                              | (5,395)                                  | (2.8)  |
| Agricultural                            | 2,195                                    | 10.0   |
| Construction                            | (3,977)                                  | (44.5) |
| Consumer                                | (765)                                    | (8.0)  |
| Other commercial and agricultural loans | 2,635                                    | 4.9    |
| State & political subdivision loans     | 8,236                                    | 12.5   |
| Total loans                             | \$ 3,143                                 | 0.6    |

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



business development officers and the opening of loan production offices.

Total loans increased \$3.1 million or 0.6% during the first nine months of 2014. The increase in loans was primarily driven by several large state and political loans, which were originated during 2014. Commercial real estate loans decreased \$5.4 million primarily as a result of several large pay-offs, particularly of participation loans during the first part of the year. The decrease in construction loans was the result of transfers to commercial real estate and municipal loans upon the completion of two projects. The increase in commercial and other loans was primarily the result of two customers with lines of credit that increased \$2.5 million.

During the first three quarters of 2014, we have experienced soft loan demand for commercial related loans throughout our primary market. As a result of this soft demand, there has also been an increase in pricing pressure for the loan demand that we are seeing in our markets. This increased competition has resulted in the Bank changing terms of loans in order to maintain the relationship. While obtaining and maintaining commercial relationships has become more competitive, the Company is still focused on growing commercial real estate, commercial and agricultural and state and political subdivision loans as a means to increase loan growth and obtain deposits from farmers, small businesses and municipalities throughout our market area. As a community bank, we strive to meet the unique needs and provide solutions to customers within our service area. The local economy has been impacted by natural 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, exploration activities have been curtailed in 2014. We work closely with local municipalities and school districts to meet their needs that otherwise would be provided by the municipal bond market.

Loan demand for conforming mortgages, which the Company typically sells on the secondary market, also decreased in comparison to the prior year. Due to the decline in demand for non-conforming mortgages and the difficult investment environment, the Company decided during the first part of 2014 and 2013 that certain 15 year mortgage loans that met secondary market standards would not be sold on the secondary market, but would instead be held as part of the Bank's residential real estate portfolio. During the first nine months of 2014 and 2013, the Company decided not to sell \$3.7 million and \$6.9 million, respectively, of residential mortgages that met secondary market standards. During the first nine months of 2014, \$8.1 million of loans were originated to be sold on the secondary market, which compares to \$17.0 million for the comparable period in 2013. 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.

#### Allowance for Loan Losses

The allowance for loan losses is maintained at a level which in management's judgment is adequate to absorb probable future loan losses inherent in the loan portfolio. The provision for loan losses is charged against current income. Loans deemed not collectable are charged-off against the allowance while subsequent recoveries increase the allowance. The following table presents an analysis of the allowance for loan losses and non-performing loans and assets as of and for the nine months ended September 30, 2014 and for the years ended December 31, 2013, 2012, 2011 and 2010 (dollars in thousands):

|   | September<br>30,<br>2014 | 2013     | December 31,<br>2012 | 2011     | 2010     |
|---|--------------------------|----------|----------------------|----------|----------|
| Balance                                 |                          |          |                      |          |          |
| at beginning of period                  | \$ 7,098                 | \$ 6,784 | \$ 6,487             | \$ 5,915 | \$ 4,888 |
| Charge-offs:                            |                          |          |                      |          |          |
| Real estate:                            |                          |          |                      |          |          |
| Residential                             | 45                       | 17       | 95                   | 101      | 147      |
| Commercial                              | 486                      | 62       | 2                    | 29       | 53       |
| Agricultural                            | -                        | -        | -                    | -        | -        |
| Consumer                                | 40                       | 54       | 54                   | 71       | 35       |
| Other commercial and agricultural loans | 221                      | 1        | 21                   | 6        | 173      |
| Total loans charged-off                 | 792                      | 134      | 172                  | 207      | 408      |
| Recoveries:                             |                          |          |                      |          |          |
| Real estate:                            |                          |          |                      |          |          |
| Residential                             | -                        | 5        | -                    | -        | 4        |
| Commercial                              | 9                        | 5        | 9                    | 15       | 11       |
| Agricultural                            | -                        | -        | -                    | -        | -        |
| Consumer                                | 21                       | 33       | 33                   | 57       | 45       |
| Other commercial and agricultural loans | -                        | -        | 7                    | 32       | 120      |

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|   |               |            |            |            |         |
|---|---------------|------------|------------|------------|---------|
| Total loans recovered   | 30            | 43         | 49         | 104        | 180     |
| Net loans charged-off   | 762           | 91         | 123        | 103        | 228     |
| Provision charged to expense                                      | 480           | 405        | 420        | 675        | 1,255   |
| Balance at end of year  | \$ 6,816 \$   | 7,098 \$   | 6,784 \$   | 6,487 \$   | 5,915   |
| Loans outstanding at end of period                                | \$ 543,755 \$ | 540,612 \$ | 502,463 \$ | 487,509 \$ | 473,517 |
| Average loans outstanding, net                                    | \$ 537,590 \$ | 516,748 \$ | 496,822 \$ | 474,972 \$ | 468,620 |
| Non-performing assets:  |               |            |            |            |         |
| Non-accruing loans  | \$ 6,751 \$   | 8,097 \$   | 8,067 \$   | 9,165 \$   | 11,853  |
| Accrual loans - 90 days or more past due                          | 763           | 697        | 506        | 275        | 692     |
| Total non-performing loans  | \$ 7,514 \$   | 8,794 \$   | 8,573 \$   | 9,440 \$   | 12,545  |
| Foreclosed assets held for sale                                   | 1,564         | 1,360      | 616        | 860        | 693     |
| Total non-performing assets                                       | \$ 9,078 \$   | 10,154 \$  | 9,189 \$   | 10,300 \$  | 13,238  |
| Annualized net charge-offs to average loans                       | 0.19%         | 0.02%      | 0.02%      | 0.02%      | 0.05%   |
| Allowance to total loans  | 1.25%         | 1.31%      | 1.35%      | 1.33%      | 1.25%   |
| Allowance to total non-performing loans                           | 90.71%        | 80.71%     | 79.13%     | 68.72%     | 47.15%  |
| Non-performing loans as a percent of loans net of unearned income | 1.38%         | 1.63%      | 1.71%      | 1.94%      | 2.65%   |
| Non-performing assets as a percent of loans                       | 1.67%         | 1.88%      | 1.83%      | 2.11%      | 2.80%   |

net of  
unearned  
income

43

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Management believes it uses the best information available when estimating the allowance for loan losses and that the allowance for loan losses is adequate as of September 30, 2014. 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 chose to include. Watch list loans are continually monitored going forward until satisfactory conditions exist that allow management to upgrade and remove the loan. In certain cases, loans may be placed on non-accrual status or charged-off based upon management's evaluation of the borrower's ability to pay. All commercial loans, which include commercial real estate, agricultural real estate, state and political subdivision loans and other commercial loans, on non-accrual are evaluated quarterly for impairment.

The balance in the allowance for loan losses was \$6,816,000 or 1.25% of total loans as of September 30, 2014 as compared to \$7,098,000 or 1.31% of loans as of December 31, 2013. The \$282,000 decrease is a result of a \$480,000 provision for the first nine months offset by net charge-offs of \$762,000. The net charge-offs for 2014 are significantly higher than historical charge-offs for the Bank, primarily as a result of two relationships. In June, we recorded charge-offs for these two relationships of \$463,000 and \$145,000, respectively, which in the prior quarter had been specifically reserved for as part of the allowance calculation. Net charge-offs for all of 2013 were \$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 September 30, 2014 and December 31, 2013, 2012, 2011 and 2010:

|   | September 30,<br>2014 |       | 2013     |       | December 31<br>2012 |       | 2011     |       | 2010     |       |
|---|-----------------------|-------|----------|-------|---------------------|-------|----------|-------|----------|-------|
|   | Amount                | %     | Amount   | %     | Amount              | %     | Amount   | %     | Amount   | %     |
| Real estate<br>loans:                         |                       |       |          |       |                     |       |          |       |          |       |
| Residential                                   | \$ 886                | 34.5  | \$ 946   | 34.6  | \$ 875              | 35.4  | \$ 805   | 37.7  | \$ 969   | 39.1  |
| Commercial,<br>agricultural                   | 3,703                 | 39.0  | 4,558    | 39.8  | 4,437               | 38.8  | 4,132    | 37.9  | 3,380    | 36.2  |
| Construction                                  | 23                    | 0.9   | 50       | 1.7   | 38                  | 2.4   | 15       | 1.7   | 22       | 2.1   |
| Consumer                                      | 86                    | 1.6   | 105      | 1.7   | 119                 | 2.1   | 111      | 2.2   | 108      | 2.4   |
| Other<br>commercial and<br>agricultural loans | 1,163                 | 10.4  | 942      | 10.0  | 728                 | 9.5   | 674      | 9.1   | 983      | 10.0  |
| State & political<br>subdivision loans        | 450                   | 13.6  | 330      | 12.2  | 271                 | 11.8  | 235      | 11.4  | 137      | 10.2  |
| Unallocated                                   | 505                   | N/A   | 167      | N/A   | 316                 | N/A   | 515      | N/A   | 316      | N/A   |
| Total allowance<br>for loan losses            | \$ 6,816              | 100.0 | \$ 7,098 | 100.0 | \$ 6,784            | 100.0 | \$ 6,487 | 100.0 | \$ 5,915 | 100.0 |



As a result of previous loss experiences and other risk factors utilized in determining the allowance, the Bank's allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 39.0% of the loan portfolio, 54.3% of the allowance is assigned to this segment of the loan portfolio as these loans have more inherent risks than residential real estate or loans to state and political subdivisions.

The following table identifies amounts of loans contractually past due 30 to 89 days and non-performing loans by loan category, as well as the change from December 31, 2013 to September 30, 2014 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.

| (in thousands)                          | September 30, 2014<br>Non-Performing Loans |                        |                 |                          | December 31, 2013<br>Non-Performing Loans |                     |                 |                          |
|---|--|------------------------|-----------------|--------------------------|---|---------------------|-----------------|--------------------------|
|   | 30 - 89<br>Days                            |                        |                 |                          | 30 - 89<br>Days                           |                     |                 |                          |
|   | Past Due                                   | 90 Days<br>Past<br>Due | Non-<br>accrual | Total Non-<br>Performing | Past Due                                  | 90 Days Past<br>Due | Non-<br>accrual | Total Non-<br>Performing |
|   | Accruing                                   | Accruing               |                 |                          | Accruing                                  | Accruing            |                 |                          |
| Real estate:                            |  |                        |                 |                          |   |                     |                 |                          |
| Residential                             | \$ 1,025                                   | \$ 432                 | \$ 913          | \$ 1,345                 | \$ 1,006                                  | \$ 352              | \$ 685          | \$ 1,037                 |
| Commercial                              | 408  | 331                    | 5,003           | 5,334                    | 215                                       | 344                 | 7,247           | 7,591                    |
| Agricultural                            | 42   | -                      | -               | -                        | -   | -                   | -               | -                        |
| Construction                            | -  | -                      | -               | -                        | -   | -                   | -               | -                        |
| Consumer                                | 56   | -                      | 50              | 50                       | 132                                       | 1                   | 15              | 16                       |
| Other commercial and agricultural loans |  |                        |                 |                          |   |                     |                 |                          |
|   | 21   | -                      | 785             | 785                      | 17  | -                   | 150             | 150                      |
| Total nonperforming loans               | \$ 1,552                                   | \$ 763                 | \$ 6,751        | \$ 7,514                 | \$ 1,370                                  | \$ 697              | \$ 8,097        | \$ 8,794                 |

| (in thousands)   | Change in<br>Non-Performing Loans<br>September 30, 2014<br>/December 31, 2013 |        |
|------------------|---|--------|
|                  | Amount  | %      |
| Real estate:     |   |        |
| Residential      | \$ 308  | 29.7   |
| Commercial       | (2,257)   | (29.7) |
| Agricultural     | -   | N/A    |
| Construction     | -   | N/A    |
| Consumer         | 34  | 212.5  |
| Other commercial | 635   | 423.3  |

and agricultural  
loans

|                                 |            |        |
|---------------------------------|------------|--------|
| Total<br>nonperforming<br>loans | \$ (1,280) | (14.6) |
|---------------------------------|------------|--------|

For the nine month period ending September 30, 2014, we recorded a provision for loan losses of \$480,000, which compares to \$315,000 for the same time period in 2013. Non-performing loans decreased \$1.3 million or 14.6%, from December 31, 2013 to September 30, 2014. The decrease was primarily attributable to the charge-offs of two relationships previously mentioned and two foreclosures completed in the second and third quarters of 2014. Approximately 64.2% of the Bank's non-performing loans are associated with the following three customer relationships:

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- A commercial customer with a total loan relationship of \$3.7 million secured by 164 residential properties was considered non-accrual as of September 30, 2014. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. In July of 2013, the customer filed for bankruptcy under Chapter 11 and a Trustee was appointed in January of 2014. Through September 30, 2014 all loan payments in accordance with the forbearance agreement have been made, which has resulted in no specific reserve allocation as of September 30, 2014. We continue to monitor the bankruptcy proceedings to identify potential changes in the customer's operations and the impact these would have on the loan payments for our loans to the customer and the underlying collateral that supports these loans.
- A commercial customer with a relationship of approximately \$473,000 after a charge-off of \$463,000 during the second quarter of 2014, secured by real estate was considered non-accrual as of September 30, 2014. The current economic conditions have significantly impacted the cash flows from the customer's activities. Management reviewed the collateral and in the second quarter charged-off of a portion of the balance associated with this customer, which was based on the appraised value of collateral and as a result there is no specific reserve as of September 30, 2014.
  - A commercial customer with a relationship of approximately \$670,000 secured by real estate, equipment and accounts receivable was considered non-accrual as of September 30, 2014. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer. Management reviewed the collateral, which resulted in a specific reserve of \$6,100 as of September 30, 2014.

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

- One loan relationship comprises 49.0% of the non-performing loan balance, whose debt is current through September 30, 2014.
- Net and gross charge-offs continue to be comparable to the Bank's peer group, even though they are higher than the Bank's historical standard. Annualized net charge-offs for 2014 are 0.19% of the total loan portfolio, which is higher than 2013's ratio of 0.02%.
- The primary market of the Bank has a relatively stable real estate market and did not experience 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 a 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 purchased bank owned life insurance to offset future employee benefit costs. As of September 30, 2014, the cash surrender value of this life insurance is \$15,045,000, which has resulted in income recognized in the first nine months of 2014 of \$366,000 compared to \$377,000 during the comparable period in 2013. The use of life insurance policies provides the Bank with an asset that will generate earnings to partially offset the current costs of benefits and eventually (at the death of the individuals) provides partial recovery of cash outflows associated with the benefits.

#### Premises and Equipment

Premises and equipment increased from \$11.1 million at December 31, 2013 to \$11.8 million at September 30, 2014. This occurred primarily as a result of transfer from other assets for land held for expansion and costs associated with

the construction of a branch in the Lock Haven market, where we currently have a loan production office. There were other purchases of equipment totaling \$526,000 and depreciation of \$407,000 in 2014.

#### Deposits

The following table shows the composition of deposits as of September 30, 2014 and December 31, 2013 (dollars in thousands):

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|                               | September 30,<br>2014 |       | December 31,<br>2013 |       |
|-------------------------------|-----------------------|-------|----------------------|-------|
|                               | Amount                | %     | Amount               | %     |
| Non-interest-bearing deposits | \$ 94,049             | 12.2  | \$ 85,585            | 11.4  |
| NOW accounts                  | 216,442               | 28.2  | 215,656              | 28.8  |
| Savings deposits              | 103,723               | 13.5  | 95,678               | 12.8  |
| Money market deposit accounts | 100,254               | 13.1  | 85,038               | 11.4  |
| Certificates of deposit       | 253,574               | 33.0  | 266,359              | 35.6  |
| Total                         | \$ 768,042            | 100.0 | \$ 748,316           | 100.0 |

|                               | September 30, 2014/<br>December 31, 2013<br>Change |       |
|-------------------------------|--|-------|
|                               | Amount   | %     |
| Non-interest-bearing deposits | \$ 8,464   | 9.9   |
| NOW accounts                  | 786  | 0.4   |
| Savings deposits              | 8,045  | 8.4   |
| Money market deposit accounts | 15,216   | 17.9  |
| Certificates of deposit       | (12,785)   | (4.8) |
| Total                         | \$ 19,726  | 2.6   |

Deposits increased \$19.7 million since December 31, 2013. The biggest increase was in money market deposit accounts, which increased \$15.2 million and is primarily driven by an increase in state and political deposits. The increase in savings accounts of \$8.0 million was primarily the result of one customer, which increased \$4.7 million who is in the middle of a construction project and has deposited construction funds with the Bank. The increase in non-interest bearing deposits of \$8.5 million was a result of increases across numerous customers. Similar to the prior year, as CD's mature, some customers are converting the balances to other deposits accounts at the bank. This is occurring as customers are seeking more liquidity during this low rate environment. The Bank currently does not have any outstanding brokered certificates of deposit.

#### Borrowed Funds

Borrowed funds decreased \$29.2 million during the first nine months of 2014. The decrease was the result of repaying \$4.2 million of maturing terms notes from the FHLB and \$36.7 million of overnight borrowings from the FHLB. The repayments were offset by borrowing \$12.8 million from the FHLB, of which \$6.8 million had a maturity greater than one year, with the remaining \$6.0 million maturing in nine months from the date it was borrowed. Additionally, there was a decrease of approximately \$1.1 million in the balances outstanding under repurchase agreements. The Bank's current strategy for borrowings is to consider terms and structures to manage interest rate risk and liquidity in a potential rising interest rate environment. The Company's daily cash requirements or short-term investments are primarily met by using the financial instruments available through the Federal Home Loan Bank of Pittsburgh.

In December 2003, the Company formed a special purpose entity Citizens Financial Statutory Trust I (“the Entity”), to issue \$7,500,000 of floating rate obligated mandatory redeemable securities as part of a pooled offering. The rate is determined quarterly based on the 3 month LIBOR plus 2.80%. The Entity may redeem them, in whole or in part, at face value at any time. The Company borrowed the proceeds of the issuance from the Entity in December 2003 in the form of a \$7,500,000 note payable, which is included within “Borrowed Funds” in the liabilities section of the Company’s balance sheet. Under current accounting rules, the Company’s minority interest in the Entity was recorded at the initial investment amount and is included in the other assets section of the balance sheet. The Entity is not consolidated as part of the Company’s consolidated financial statements.

## Stockholder's Equity

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

Total stockholders' equity was \$99.2 million at September 30, 2014 compared to \$92.1 million at December 31, 2013, an increase of \$7.1 million or 7.7%. Excluding accumulated other comprehensive income (loss) stockholders' equity increased \$4.4 million, or 4.7%. The Company purchased 10,759 shares of treasury stock at a weighted average cost of \$52.34 per share. The Company reissued 7,510 shares as part of the dividend reinvestment program at a weighted average cost of \$50.13 and 392 shares that were awarded as part of the restricted stock plan at a weighted average cost of \$48.36. In the first nine months of 2014, the Company had net income of \$9.9 million and declared cash dividends of \$5.4 million, or \$1.77 per shares, representing a cash dividend payout ratio of 54.4%. Of the \$1.77 per share dividend declared, \$0.60 per share represented a special cash dividend that was declared during the third quarter of 2014, which resulted in the higher than average dividend payout ratio for the Company.

All of the Company's investment securities are classified as available-for-sale, making this portion of the Company's balance sheet more sensitive to the changing market value of investments. As a result of changes in the interest rate environment, accumulated other comprehensive income (loss) associated with the change in investment securities increased \$2.7 million from December 31, 2013 and accounts for the majority of the total change in accumulated other comprehensive income (loss) of \$2.7 million.

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

|  | September 30,<br>2014 |        | December 31,<br>2013 |        |
|--|-----------------------|--------|----------------------|--------|
| Total capital (to<br>risk-weighted<br>assets)  | Amount                | Ratio  | Amount               | Ratio  |
| Company  | \$ 104,740            | 18.28% | \$ 100,320           | 17.75% |
| For capital<br>adequacy<br>purposes            | 45,830                | 8.00%  | 45,211               | 8.00%  |
| To be well<br>capitalized                      | 57,288                | 10.00% | 56,514               | 10.00% |
| Tier I capital (to<br>risk-weighted<br>assets) |                       |        |                      |        |
| Company  | \$ 97,507             | 17.02% | \$ 92,902            | 16.44% |
| For capital<br>adequacy<br>purposes            | 22,915                | 4.00%  | 22,606               | 4.00%  |

|                                    |           |        |           |        |
|------------------------------------|-----------|--------|-----------|--------|
| To be well capitalized             | 34,373    | 6.00%  | 33,908    | 6.00%  |
| Tier I capital (to average assets) |           |        |           |        |
| Company                            | \$ 97,507 | 10.78% | \$ 92,902 | 10.42% |
| For capital adequacy purposes      | 36,190    | 4.00%  | 35,669    | 4.00%  |
| To be well capitalized             | 45,237    | 5.00%  | 44,587    | 5.00%  |

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

|  | September 30,<br>2014 |        | December 31,<br>2013 |        |
|--|-----------------------|--------|----------------------|--------|
| Total capital (to risk-weighted assets)  | Amount                | Ratio  | Amount               | Ratio  |
| Bank                                     | \$ 102,744            | 17.98% | \$ 97,863            | 17.35% |
| For capital adequacy purposes            | 45,704                | 8.00%  | 45,135               | 8.00%  |
| To be well capitalized                   | 57,130                | 10.00% | 56,418               | 10.00% |
| Tier I capital (to risk-weighted assets) |                       |        |                      |        |
| Bank                                     | \$ 95,632             | 16.74% | \$ 90,639            | 16.07% |
| For capital adequacy purposes            | 22,852                | 4.00%  | 22,567               | 4.00%  |
| To be well capitalized                   | 34,278                | 6.00%  | 33,851               | 6.00%  |
| Tier I capital (to average assets)       |                       |        |                      |        |
| Bank                                     | \$ 95,632             | 10.59% | \$ 90,639            | 10.18% |
| For capital adequacy purposes            | 36,132                | 4.00%  | 35,615               | 4.00%  |
| To be well capitalized                   | 45,165                | 5.00%  | 44,519               | 5.00%  |

## Off Balance Sheet Activities

Some financial instruments, such as loan commitments, credit lines, and letters of credit are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at September 30, 2014 and December 31, 2013 (in thousands):

|                                    | September<br>30, 2014 | December<br>31, 2013 |
|------------------------------------|-----------------------|----------------------|
| Commitments<br>to extend<br>credit | \$ 119,511            | \$ 89,847            |
| Standby<br>letters of<br>credit    | 10,176                | 12,014               |
|                                    | \$ 129,687            | \$ 101,861           |

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing. Overdraft charges as a result of ATM withdrawals and one time point of sale (non-recurring) transactions require prior approval of the customer. The non-contractual amount of financial instruments with off-balance sheet risk at September 30, 2014 and December 31, 2013 was \$12,357,000 and \$12,450,000, respectively. The Company reserves the right to discontinue this service without prior notice.

## Liquidity

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

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

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other significant uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures (including software purchases), during the first nine months of 2014 were \$555,000, compared to \$339,000 during the same time period in 2013.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short-term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$262.3 million, of which \$24.1 million was outstanding at September 30, 2014. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon. We also have a borrower in custody line with the Federal Reserve Bank of approximately \$9.0 million, which also is not drawn upon as of September 30, 2014. The Company continues to evaluate its liquidity needs and as necessary finds additional sources.





Citizens Financial Services, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial's primary source of income is dividends received from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. In particular, the Bank may not, as a state-chartered bank which is a member of the Federal Reserve System, declare a dividend without approval of the Federal Reserve, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At September 30, 2014, Citizens Financial Services, Inc. had liquid assets of \$1.0 million.

#### Interest Rate and Market Risk Management

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

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk and, since our Company has no trading portfolio, it is not subject to trading risk. Currently, our Company has equity securities that represent only .6% of our investment portfolio and, therefore, equity risk is not significant.

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

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

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 September 30, 2014 (dollars in thousands):

|                      | Change In           | % Change In         |
|----------------------|---------------------|---------------------|
| Prospective One-Year | Prospective         | Prospective         |
| Net Interest Income  | Net Interest Income | Net Interest Income |

Changes  
in Rates

|       |    |        |    |         |         |
|-------|----|--------|----|---------|---------|
| -100  | \$ | 29,529 | \$ | (223)   | (0.75)  |
| Shock |    |        |    |         |         |
| Base  |    | 29,752 |    | -       | -       |
| +100  |    | 28,677 |    | (1,075) | (3.61)  |
| Shock |    |        |    |         |         |
| +200  |    | 27,722 |    | (2,030) | (6.82)  |
| Shock |    |        |    |         |         |
| +300  |    | 26,816 |    | (2,936) | (9.87)  |
| Shock |    |        |    |         |         |
| +400  |    | 25,788 |    | (3,964) | (13.32) |
| Shock |    |        |    |         |         |

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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.

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

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

No material changes in market risk strategy occurred during the current period. A detailed discussion of market risk is provided in the SEC Form 10-K for the period ended December 31, 2013.

### Item 4-Control and Procedures

#### (a) Disclosure Controls and Procedures

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

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

There were no changes in the Company’s internal control over financial reporting during the quarter ended September 30, 2014 that have materially affected, or are reasonable likely to materially affect, the Company’s internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1 - Legal Proceedings

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

## Item 1A – Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1.A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business, financial condition or future results. At September 30, 2014 the risk factors of the Company have not changed materially from those reported in our Annual Report on Form 10-K. However, the risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

## ISSUER PURCHASES OF EQUITY SECURITIES

| Period               | Total Number<br>of<br>Shares (or units<br>Purchased) | Average Price<br>Paid per Share<br>(or Unit) | Total Number of<br>Shares (or Units)<br>Purchased as Part of<br>Publicly<br>Announced Plans of<br>Programs | Maximum Number (or<br>Approximate Dollar<br>Value) of Shares (or<br>Units) that May Yet Be<br>Purchased Under the<br>Plans or Programs (1) |
|----------------------|--|--|--|--|
| 7/1/14 to<br>7/31/14 | -  | -  | -  | 77,716   |
| 8/1/14 to<br>8/31/14 | -  | -  | -  | 77,716   |
| 9/1/14 to<br>9/30/14 | -  | -  | -  | 77,716   |
| Total                | -  | -  | -  | 77,716   |

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

Item 3 - Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosure

Not applicable.

Item 5 - Other Information

None

Item 6 - Exhibits

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

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

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

4.1 Form of Common Stock Certificate.(3)

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

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

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

101 \*\* The following materials from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) The Consolidated Balance Sheet (unaudited), (ii) the Consolidated Statement of Income (unaudited), (iii) the Consolidated Statement of Comprehensive Income (unaudited), (iv) the Consolidated Statement of Cash Flows (unaudited) and (v) related notes (unaudited).

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

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

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

\*\* Furnished, not filed.

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Signatures

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

Citizens Financial Services, Inc.  
(Registrant)

November 6, 2014

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

November 6, 2014

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

