CITIZENS FINANCIAL SERVICES INC
Form 10-Q
November 12, 2010

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

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

For the quarterly period ended September 30, 2010
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 __X__ No_____

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes _____ No_____

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

Large accelerated filer ____ Accelerated filer ____

Non-accelerated filer ____ Smaller reporting company __X__
(Do not check if a smaller reporting company)

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

The number of outstanding shares of the Registrant's Common Stock, as of October 28, 2010, was 2,891,697.

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

(in thousands except share data)	September 30 2010	December 31 2009
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	$ 11,392	$ 9,505
Interest-bearing	28,674	21,944
Total cash and cash equivalents	40,066	31,449
Available-for-sale securities	230,493	198,582
Loans (net of allowance for loan losses: 2010, $5,588 and 2009, $4,888)	469,204	451,496
Premises and equipment	12,944	12,227
Accrued interest receivable	3,636	3,141
Goodwill	10,256	10,256
Bank owned life insurance	13,043	12,667
Other assets	9,713	9,659
TOTAL ASSETS	$ 789,355	$ 729,477
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 68,794	$ 60,061
Interest-bearing	586,446	545,498
Total deposits	655,240	605,559
Borrowed funds	56,454	54,115
Accrued interest payable	1,814	2,037
Other liabilities	6,225	6,239
TOTAL LIABILITIES	719,733	667,950
STOCKHOLDERS' EQUITY:		
Preferred Stock		
$1.00 par value; authorized 3,000,000 shares at September 30, 2010 and none at December 31, 2009; none issued at September 30, 2010 and December 31, 2009	-	-
Common stock		
$1.00 par value; authorized 15,000,000 shares at September 30, 2010 and 10,000,000 at December 31, 2009; issued 3,104,434 shares at September 30, 2010 and 3,076,253 at December 31, 2009	3,104	3,076
Additional paid-in capital	14,219	13,457
Retained earnings	52,968	47,353
Accumulated other comprehensive income	3,984	2,041

Treasury stock, at cost: 212,767 shares at September 30, 2010 and 204,437 shares at December 31, 2009		(4,653)		(4,400)
TOTAL STOCKHOLDERS' EQUITY		69,622		61,527
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	789,355	$	729,477

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

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

(in thousands, except share and per share data)	Three Months Ended September 30 2010	Three Months Ended September 30 2009	Nine Months Ended September 30 2010	Nine Months Ended September 30 2009
INTEREST INCOME:				
Interest and fees on loans	$ 7,782	$ 7,581	$ 23,268	$ 22,616
Interest-bearing deposits with banks	24	15	55	27
Investment securities:				
Taxable	1,178	1,466	3,777	4,647
Nontaxable	772	598	2,140	1,583
Dividends	14	7	27	20
TOTAL INTEREST INCOME	9,770	9,667	29,267	28,893
INTEREST EXPENSE:				
Deposits	2,313	2,777	7,374	8,555
Borrowed funds	444	500	1,324	1,519
TOTAL INTEREST EXPENSE	2,757	3,277	8,698	10,074
NET INTEREST INCOME	7,013	6,390	20,569	18,819
Provision for loan losses	300	400	840	700
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	6,713	5,990	19,729	18,119
NON-INTEREST INCOME:				
Service charges	919	958	2,709	2,664
Trust	130	121	411	397
Brokerage and insurance	91	75	314	228
Gains on loans sold	44	83	92	292
Investment securities gains, net	-	-	99	118
Earnings on bank owned life insurance	127	128	376	364
Other	134	87	358	278
TOTAL NON-INTEREST INCOME	1,445	1,452	4,359	4,341
NON-INTEREST EXPENSES:				
Salaries and employee benefits	2,436	2,393	7,293	7,018
Occupancy	295	272	898	889
Furniture and equipment	114	102	331	336
Professional fees	176	164	509	459
FDIC insurance	245	277	699	1,030
Other	1,220	1,242	3,440	3,581
TOTAL NON-INTEREST EXPENSES	4,486	4,450	13,170	13,313
Income before provision for income taxes	3,672	2,992	10,918	9,147
Provision for income taxes	775	604	2,348	1,941
NET INCOME	$ 2,897	$ 2,388	$ 8,570	$ 7,206
Earnings Per Share	$ 1.00	$ 0.82	$ 2.96	$ 2.48
Cash Dividends Paid Per Share	$ 0.255	$ 0.245	$ 0.760	$ 0.730

Weighted average number of shares outstanding	2,891,875	2,902,147	2,896,314	2,901,701

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

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

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands)	2010	2009	2010	2009
Net income	$ 2,897	$ 2,388	$ 8,570	$ 7,206
Other comprehensive income:				
Change in unrealized net gains on available for sale securities	1,429	4,385	3,398	5,054
Change in unrealized loss on interest rate swap	(108)	(115)	(355)	123
Less: Reclassification adjustment for gain included in net income	-	-	(99)	(118)
Other comprehensive income before tax	1,321	4,270	2,944	5,059
Income tax expense related to other comprehensive income	449	1,452	1,001	1,720
Other comprehensive income, net of tax	872	2,818	1,943	3,339
Comprehensive income	$ 3,769	$ 5,206	$ 10,513	$ 10,545

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

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

(in thousands)	Nine Months Ended September 30, 2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 8,570	$ 7,206
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	840	700
Depreciation and amortization	362	476
Amortization and accretion of investment securities	561	277
Deferred income taxes	49	155
Investment securities gains, net	(99)	(118)
Realized gains on loans sold	(92)	(292)
Earnings on bank owned life insurance	(376)	(364)
Originations of loans held for sale	(6,607)	(17,546)
Proceeds from sales of loans held for sale	6,699	17,838
(Gain) Loss on sale of foreclosed assets held for sale	(48)	40
Increase in accrued interest receivable	(495)	(632)
Decrease in accrued interest payable	(223)	(159)
Other, net	(748)	95
Net cash provided by operating activities	8,393	7,676
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from sales of available-for-sale-securities	8,871	6,778
Proceeds from maturity and principal repayments of securities	35,728	35,143
Purchase of securities	(73,674)	(60,548)
Purchase of regulatory stock	-	(586)
Net increase in loans	(19,585)	(16,287)
Purchase of premises and equipment	(1,227)	(1,063)

Proceeds from sale of premises and equipment	-	1,406
Proceeds from sale of foreclosed assets held for sale	665	313
Net cash used in investing activities	(49,222)	(34,844)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	49,682	33,168
Proceeds from long-term borrowings	3,163	10,545
Repayments of long-term borrowings	(3,324)	(14,050)
Net increase in short-term borrowed funds	2,500	91
Purchase of treasury stock	(381)	(192)
Dividends paid	(2,194)	(2,088)
Net cash provided by financing activities	49,446	27,474
Net increase in cash and cash equivalents	8,617	306
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	31,449	19,856
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 40,066	$ 20,162
Supplemental Disclosures of Cash Flow Information:		
Interest paid	$ 8,921	$ 10,233
Income taxes paid	$ 2,455	$ 2,025
Loans transferred to foreclosed property	$ 1,205	$ 410

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

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

Note 1 - Basis of Presentation

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

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

In the opinion of management of the Company, the accompanying interim financial statements for the periods ended September 30, 2010 and 2009 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, 2010 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, 2009.

Note 2 - Earnings per Share

The following table sets forth the computation of earnings per share. Earnings per share calculations give retroactive effect to stock dividends declared by the Company. The Company has no dilutive securities.

	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
Net income applicable to common stock	$2,897,000	$2,388,000	$8,570,000	$7,206,000
Weighted average common shares outstanding	2,891,875	2,902,147	2,896,314	2,901,701
	$1.00	$0.82	$2.96	$2.48

Earnings per
share

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, 2010 and December 31, 2009 were as follows (in thousands):

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September 30, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. Agency securities	$ 93,349	$ 1,914	$ (27)	$ 95,236
Obligations of state and political subdivisions	76,484	2,866	(53)	79,297
Corporate obligations	2,998	339	-	3,337
Mortgage-backed securities	48,497	3,059	-	51,556
Equity securities	914	190	(37)	1,067
Total available-for-sale securities	$ 222,242	$ 8,368	$ (117)	$ 230,493

December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. Agency securities	$ 64,583	$ 888	$ (248)	$ 65,223
Obligations of state and political subdivisions	58,651	1,085	(162)	59,574
Corporate obligations	2,998	168	-	3,166
Mortgage-backed securities	67,026	3,168	-	70,194
Equity securities	371	54	-	425
Total available-for-sale securities	$ 193,629	$ 5,363	$ (410)	$ 198,582

The following table shows the Company’s gross unrealized losses and fair value of the Company’s investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at September 30, 2010 and December 31, 2009 (in thousands). As of September 30, 2010 and December 31, 2009, the Company owned 12 and 33 securities whose fair value was less than their cost basis, respectively.

September 30, 2010	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Agency securities	$ 7,053	$ (27)	$ -	$ -	$ 7,053	$ (27)
Obligations of states and political subdivisions	3,858	(51)	100	(2)	3,958	(53)
Total debt securities	10,011	(78)	100	(2)	11,011	(80)
Equity securities	145	(37)	-	-	145	(37)
Total securities	$ 11,056	$ (115)	$ 100	$ (2)	$ 11,156	$ (117)

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December 31, 2009	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Agency securities	$ 28,665	$ (248)	$ -	$ -	$ 28,665	$ (248)
Obligations of states and political subdivisions	11,326	(120)	454	(42)	11,780	(162)
Total securities	$ 39,991	$ (368)	$ 454	$ (42)	$ 40,445	$ (410)

As of September 30, 2010, the Company's investment securities portfolio contained unrealized losses on obligations of U.S Agency securities, states and political subdivisions and certain equity securities. For fixed maturity investments management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more-likely-than-not that it will not be required to sell the security, before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. For equity securities where the fair value has been significantly below cost for one year, the Company's policy is to recognize an impairment loss unless sufficient evidence is available that the decline is not other than temporary and a recovery period can be predicted. The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not other than temporary and is the result of interest rate changes, sector credit rating changes, or company-specific rating changes that are not expected to result in the non-collection of principal and interest during the period.

Proceeds from sales of securities available-for-sale for the nine months ended September 30, 2010 and 2009 were $8,871,000 and $6,778,000, respectively. For the three months ended September 30, 2010 and 2009, there were no sales of available-for-sale securities. The gross gains and losses were as follows (in thousands):

	Three Months Ended September 30		Nine months Ended September 30	
	2010	2009	2010	2009
Gross gains	$ -	$ -	$ 99	$ 209

Gross losses	-	-	-	91
Net gains	$ -	$ -	$ 99	$ 118

Investment securities with an approximate carrying value of $153,591,000 and $144,880,000 at September 30, 2010 and December 31, 2009, respectively, were pledged to secure public funds and certain other deposits as provided by law.

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, 2010, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 2,747	$ 2,765
Due after one year through five years	63,656	64,666
Due after five years through ten years	31,545	33,080
Due after ten years	123,380	128,915
Total	$ 221,328	$ 229,426

Note 5 – Loans

The Company grants commercial, industrial, agricultural, residential, and consumer loans primarily to customers throughout North Central Pennsylvania and Southern New York. Although the Company believes it had a diversified loan portfolio at September 30, 2010 and December 31, 2009, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions. The major classifications of loans are as follows (in thousands):

	September 30 2010 Amount	December 31, 2009 Amount
Real estate:		
Residential	$ 191,655	$ 194,989
Commercial	145,954	133,953
Agricultural	19,366	19,485
Construction	9,565	5,619
Loans to individuals		
for household, family and other purchases	11,640	11,895
Commercial and other loans	48,820	44,101
State & political subdivision loans	47,792	46,342
Total loans	474,792	456,384
Less allowance for loan losses	5,588	4,888
Net loans	$ 469,204	$ 451,496

The Company had non-accrual loans, inclusive of impaired loans, of $11,820,000 and $5,871,000 at September 30, 2010 and December 31, 2009, respectively. Information with respect to impaired loans as of and for the periods ended September 30, 2010 and December 31, 2009 are as follows (in thousands):

	September 30, 2010	December 31, 2009
Impaired loans without related allowance for loan losses	$ 4,749	$ 4,345
Impaired loans with related allowance for loan losses	6,800	799
Related allowance for loan losses	297	115
Average recorded balance of impaired loans	8,550	2,980

Interest income recognized on impaired loans for the periods ended September 30, 2010 and 2009 was $126,000 and $17,000, respectively.

Changes in the allowance for loan losses were as follows (in thousands):

(in thousands)	Three Months Ended September 30		Nine Months Ended September 30	
	2010	2009	2010	2009
Balance, at beginning of period	$ 5,302	$ 4,622	$ 4,888	$ 4,378
Provision charged to income	300	400	840	700
Increase related to acquisition			-	-
Recoveries on loans previously charged against the allowance	20	48	144	91
	5,622	5,070	5,872	5,169
Loans charged against the allowance	(34)	(387)	(284)	(486)
Balance, at end of year	$ 5,588	$ 4,683	$ 5,588	$ 4,683

The following is a summary of the past due and non-accrual loans as of September 30, 2010 and December 31, 2009 (in thousands):

	September 30, 2010		
	30 - 90 Days Past Due	90 Days Past Due Accruing	Non-accrual
Real estate:			
Residential	$ 1,245	$ 215	$ 467
Commercial	1,585	1,305	7,523
Agricultural	-	18	2,301
Construction	-	-	-
Loans to individuals for household, family and other purchases	62	3	2
Commercial and other loans	57	19	1,527
State & political	-	-	-

subdivision loans			
Total nonperforming loans	$ 2,956	$ 1,560	$ 11,820

(in thousands)	December 31, 2009 30 - 90 Days Past Due	90 Days Past Due Accruing	Non-accrual
Real estate:			
Residential	$ 1,629	$ 75	$ 775
Commercial	1,558	635	1,863
Agricultural	75	-	2,094
Construction	-	-	749
Loans to individuals for household, family and other purchases	88	10	36
Commercial and other loans	610	75	354
State & political subdivision loans	-	89	-
Total nonperforming loans	$ 3,960	$ 884	$ 5,871

Note 6 – Federal Home Loan Bank (FHLB) Stock

Included in Other Assets in the Consolidated Balance Sheet is the Bank's investment in the Federal Home Loan Bank (FHLB) system, of which the Bank is a member. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as a long term investment, impairment is based on ultimate recovery of par value.

As of September 30, 2010 and December 31, 2009, the Bank held $3,682,000 of stock in the FHLB. In December 2008, the FHLB announced that due largely to a decline in the fair value of a segment of its mortgage-backed securities portfolio, it had suspended payment of dividends on the stock and made a decision to no longer purchase "excess stock" from its members. The Bank's stock is not transferrable and can only be redeemed by the FHLB. Further deterioration in the financial condition of the FHLB may lead management to a conclusion that the cost of the Bank's stock in the FHLB is not recoverable, which would result in a charge to earnings for impairment of the Bank's holdings of the stock. As of September 30, 2010 and December 31, 2009, the investment in the FHLB is not deemed other-than-temporarily impaired based upon management's determination of the recoverability of par value.

Note 7 - Employee Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 10 of the Company's Consolidated Financial Statements included in the 2009 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.

The Pension Plan was amended, effective January 1, 2008, to cease eligibility for employees with a hire date of January 1, 2008 or later. In lieu of the Pension Plan, employees with a hire date of January 1, 2008 or later are eligible to receive, after meeting certain length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

The Pension Plan was also amended, effective January 1, 2008, for employees who are still eligible to participate. The amended 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, 2010 and 2009, respectively (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2010	2009	2010	2009
Service cost	$ 45	$ 90	$ 259	$ 240
Interest cost	59	116	340	309
Expected return on plan assets	(77)	(113)	(446)	(302)
Net amortization and deferral	6	37	37	99
Net periodic benefit cost	$ 33	$ 130	$ 191	$ 346

The Company expects to contribute, and has contributed, $450,000 to the Pension Plan in 2010.

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 $171,000 and $159,000 for the nine months ended September 30, 2010 and 2009, respectively.

Directors' Deferred Compensation Plan

The Company's directors may elect to defer all or portions of their fees until their retirement or termination from service. Amounts deferred under the plan earn interest based upon the highest current rate offered to certificate of deposit customers. Amounts deferred under the plan are not guaranteed and represent a general liability of the Company. Amounts included in interest expense on the deferred amounts totaled $22,000 and $28,000 for the nine months ended September 30, 2010 and 2009, respectively.

Restricted Stock Plan

Effective April 18, 2006, shareholders of the Company approved the 2006 Restricted Stock Plan (the "Plan"). Employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company's common stock and are subject to certain vesting requirements including continuous employment or service with the Company. 100,000 shares of the Company's common stock have been authorized under the Plan, which terminates April 18, 2016. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

For the nine months ended September 30, 2010 and 2009, 5,090 and 7,526 shares of restricted stock were awarded and 4,948 and 2,517 shares were vested, respectively. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. Compensation expense related to restricted stock was $94,000 and $72,000 for the nine months ended September 30, 2010 and 2009, respectively.

Supplemental Executive Retirement Plan

During 2008, the Company adopted 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, 2010 and December 31, 2009, an obligation of $647,000 and $399,000, respectively, was included in other liabilities for this plan in the consolidated balance sheet. Expenses related to this plan totaled $248,000 and $158,000 for the nine months ended September 30, 2010 and 2009.

Note 8 – Fair Value Measurements

Fair value disclosures establish 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.

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The following tables present the assets reported on the consolidated statements of financial condition at their fair value as of September 30, 2010 and December 31, 2009 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

(In thousands)	September 30, 2010			
	Level 1	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Securities available for sale:				
U.S. Agency securities	$ -	$ 95,236	$ -	$ 95,236
Obligations of state and political subdivisions	-	79,297	-	79,297
Corporate obligations	-	3,337	-	3,337
Mortgage-backed securities	-	51,556	-	51,556
Equity securities	1,067	-	-	1,067
Trust Preferred Interest Rate Swap	-	(520)	-	(520)
Fair value measurements on non-recurring basis:				
Impaired Loans	-	1,728	9,524	11,252
Other real estate owned	-	739	-	739

(In thousands)	December 31, 2009			
	Level 1	Level II	Level III	Total
Fair value measurements on a recurring basis:				
Securities available for sale:				
U.S. Agency securities	$ -	$ 65,223	$ -	$ 65,223
Obligations of state and political subdivisions	-	59,574	-	59,574

Corporate obligations	-	3,166	-	3,166
Mortgage-backed securities	-	70,194	-	70,194
Equity securities	425	-	-	425
Trust Preferred Interest Rate Swap	-	(166)	-	(166)
Fair value measurements on non-recurring basis:				
Impaired Loans	-	5,029	-	5,029
Other real estate owned	-	101	-	101

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

	September 30 2010		December 31 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	$ 40,066	$ 40,066	$ 31,449	$ 31,449
Available-for-sale securities	230,493	230,493	198,582	198,582
Net loans	469,204	490,620	451,496	466,967
Bank owned life insurance	13,043	13,043	12,667	12,667
Regulatory stock	3,957	3,957	3,957	3,957
Accrued interest receivable	3,636	3,636	3,141	3,141
Financial liabilities:				
Deposits	$ 655,240	$ 664,525	$ 605,559	$ 611,705
Borrowed funds	56,454	54,955	54,115	50,582
Trust preferred interest rate swap	520	520	166	166
Accrued interest payable	1,814	1,814	2,037	2,037

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

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

Cash and Cash Equivalents:

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

Accrued Interest Receivable and Payable:

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

Available-For-Sale Securities:

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

Loans:

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

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

Bank Owned Life Insurance:

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

Regulatory Stock:

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

Deposits:

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

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

Borrowed Funds:

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

Trust Preferred Interest Rate Swap:

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

Note 9 – Recent Accounting Pronouncements

In December 2009, the FASB issued ASU 2009-16, Accounting for Transfer of Financial Assets. ASU 2009-16 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASU 2009-16 is effective for annual periods beginning after November 15, 2009 and for interim periods within those fiscal years. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In January 2010, the FASB issued ASU 2010-01, Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash – a consensus of the FASB Emerging Issues Task Force. ASU 2010-01 clarifies that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in EPS prospectively and is not a stock dividend. ASU 2010-01 is effective for interim and annual periods ending on or after December 15, 2009 and should be applied on a retrospective basis. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of this guidance is not expected to have a significant impact on the Company's financial statements.

In February 2010, the FASB issued ASU 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In March 2010, the FASB issued ASU 2010-11, Derivatives and Hedging. ASU 2010-11 provides clarification and related additional examples to improve financial reporting by resolving potential ambiguity about the breadth of the embedded credit derivative scope exception in ASC 815-15-15-8. ASU 2010-11 is effective at the beginning of the first fiscal quarter beginning after September 15, 2010. The Company is currently evaluating the impact the adoption of this standard will have on the Company's financial position or results of operation.

In April 2010, the FASB issued ASU 2010-18, Receivables (Topic 310): Effect of a Loan Modification When the Loan is a Part of a Pool That is Accounted for as a Single Asset – a consensus of the FASB Emerging Issues Task Force. ASU 2010-18 clarifies the treatment for a modified loan that was acquired as part of a pool of assets. Refinancing or restructuring the loan does not make it eligible for removal from the pool, the FASB said. The amendment will be effective for loans that are part of an asset pool and are modified during financial reporting periods that end July 15, 2010 or later is not expected to have a significant impact on the Company's financial statements

In July 2010, FASB issued ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The Company is currently evaluating the impact the adoption of this guidance will have on the Company's financial position or results of operations.

In August, 2010, the FASB issued ASU 2010-21, Accounting for Technical Amendments to Various SEC Rules and Schedules. This ASU amends various SEC paragraphs pursuant to the issuance of Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules, and Codification of Financial Reporting Policies and is not expected to have a significant impact on the Company’s financial statements.

In August, 2010, the FASB issued ASU 2010-22, Technical Corrections to SEC Paragraphs – An announcement made by the staff of the U.S. Securities and Exchange Commission. This ASU amends various SEC paragraphs based on external comments received and the issuance of SAB 112, which amends or rescinds portions of certain SAB topics and is not expected to have a significant impact on the Company's financial statements.

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

Forward-Looking Statements

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

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

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

Introduction

The following is management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in its accompanying consolidated financial statements for the Company. Our Company's consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three months and nine months ended September 30, 2010 are not necessarily indicative of the results you may expect for the full year.

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Our Company currently engages in the general business of banking throughout our service area of Potter, Tioga and Bradford counties in North Central Pennsylvania and Allegany, Steuben, Chemung and Tioga counties in Southern New York. We maintain our main office in Mansfield, Pennsylvania. Presently we operate 17 banking facilities. In Pennsylvania, these offices are located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, the Wellsboro Weis Market store, and the Mansfield Wal-Mart Super Center. In New York, we have a branch office in Wellsville, Allegany County.

Risk Management

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

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

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

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

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

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

Competition

We face strong competition in the communities that we serve from other commercial banks, savings banks, and savings and loan associations, some of which are substantially larger institutions than the Bank. In addition, insurance companies, investment-counseling firms, and other business firms and individuals offer personal and corporate trust services. We also compete with credit unions, issuers of money market funds, securities brokerage firms, consumer finance companies, mortgage brokers and insurance companies. These entities are strong competitors for virtually all types of financial services. The financial services industry continues to experience tremendous change to competitive barriers between bank and non-bank institutions. We must compete not only with traditional financial institutions, but also other business corporations that have begun to deliver competing financial services and banking services that are easily accessible through the internet. Competition for banking services is primarily based on price, nature of product, quality of service, and convenience of location.

Trust and Investment 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, 2010 and December 31, 2009, the Trust Department had $91.0 and $85.9 million of assets under management, respectively. The $5.1 million increase is primarily attributable to net additions of $3.4 million with the remaining increase the result of fluctuations in the stock market.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance. The assets associated with these products are not included in the consolidated financial statements since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from $48.6 million at December 31, 2009 to $66.2 million at September 30, 2010. 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.

Results of Operations

Overview of the Income Statement

The Company had net income of $8,570,000 for the first nine months of 2010 compared to earnings of $7,206,000 for last year's comparable period, an increase of $1,364,000 or 18.9%. Earnings per share for the first nine months of 2010 were $2.96, compared to $2.48 last year, representing a 19.4% increase. Annualized return on assets and return on equity for the nine months of 2010 were 1.51% and 18.31%, respectively, compared with 1.39% and 17.46% for last year's comparable period.

Net income for the three months ended September 30, 2010 was $2,897,000 compared to earnings of $2,388,000 in the comparable 2009 period, an increase of $509,000. Earnings per share for the three months ended September 30, 2010 and 2009 were $1.00 and $0.82 per share, respectively. Annualized return on assets and return on equity for the quarter ended September 30, 2010 was 1.49% and 17.98%, respectively, compared with 1.35% and 16.84% for the same 2009 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 2010 was $20,569,000, an increase of $1,750,000, or 9.3%, compared to the same period in 2009. For the first nine months of 2010, the provision for loan losses totaled $840,000, an increase of $140,000 over the comparable period in 2009. Consequently, net interest income after the provision for loan losses was $19,729,000 compared to $18,119,000 during the first nine months of 2009.

For the three months ended September 30, 2010, net interest income was $7,013,000 compared to $6,390,000, an increase of $623,000, or 9.8% over the comparable period in 2009. The provision for loan losses this quarter was $300,000 compared to $400,000 for last year's third quarter. Consequently, net interest income after the provision for loan losses was $6,713,000 for the quarter ended compared to $5,990,000 in 2009.

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 rate "spread" created for the nine months and three months ended September 30, 2010 and 2009 on a tax equivalent basis:

	Analysis of Average Balances and Interest Rates (1)					
	Nine Months Ended					
	September 30, 2010			September 30, 2009		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%
ASSETS						
Short-term investments:						
Interest-bearing deposits at banks	25,555	55	0.29	19,894	27	0.18
Total short-term investments	25,555	55	0.29	19,894	27	0.18
Investment securities:						
Taxable	145,917	3,804	3.48	131,218	4,667	4.74
Tax-exempt (3)	67,474	3,243	6.41	49,726	2,399	6.43
Total investment securities	213,391	7,047	4.40	180,944	7,066	5.21
Loans:						
Residential mortgage loans	202,500	10,746	7.09	204,144	11,112	7.28
Commercial & farm loans	206,158	10,345	6.71	178,301	9,284	6.96
Loans to state & political subdivisions	46,810	2,069	5.91	46,439	2,144	6.17
Other loans	11,526	751	8.71	11,436	761	8.89
Loans, net of discount (2)(3)(4)	466,994	23,911	6.85	440,320	23,301	7.08
Total interest-earning assets	705,940	31,013	5.87	641,158	30,394	6.34
Cash and due from banks	9,450			9,476		
Bank premises and equipment	12,577			11,813		
Other assets	28,917			27,496		
Total non-interest earning assets	50,944			48,785		
Total assets	756,884			689,943		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
NOW accounts	149,503	794	0.71	120,999	732	0.81
Savings accounts	53,519	120	0.30	46,216	110	0.32
Money market accounts	45,151	189	0.56	41,513	262	0.84
Certificates of deposit	322,036	6,271	2.60	302,617	7,451	3.29
Total interest-bearing deposits	570,209	7,374	1.73	511,345	8,555	2.24
Other borrowed funds	53,281	1,324	3.32	58,175	1,519	3.49
Total interest-bearing liabilities	623,490	8,698	1.87	569,520	10,074	2.36

Demand deposits	63,366		56,564	
Other liabilities	7,641		8,830	
Total non-interest-bearing liabilities	71,007		65,394	
Stockholders' equity	62,387		55,029	
Total liabilities & stockholders' equity	756,884		689,943	
Net interest income		22,315		20,320
Net interest spread (5)		4.00%		3.97%
Net interest income as a percentage				
of average interest-earning assets		4.23%		4.24%
Ratio of interest-earning assets				
to interest-bearing liabilities		1.13		1.13

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

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

	September 30, 2010			September 30, 2009		
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	$	$	%	$	$	%
ASSETS						
Short-term investments:						
Interest-bearing deposits at banks	32,773	24	0.29	22,956	15	0.27
Total short-term investments	32,773	24	0.29	22,956	15	0.27
Investment securities:						
Taxable	145,997	1,192	3.26	135,243	1,473	4.36
Tax-exempt (3)	73,402	1,170	6.38	55,926	905	6.47
Total investment securities	219,399	2,362	4.30	191,169	2,378	4.98
Loans:						
Residential mortgage loans	204,473	3,636	7.05	201,992	3,649	7.17
Commercial & farm loans	209,849	3,411	6.45	185,403	3,191	6.83
Loans to state & political subdivisions	47,126	694	5.85	46,472	706	6.03
Other loans	11,503	250	8.62	11,751	260	8.74
Loans, net of discount (2)(3)(4)	472,951	7,991	6.70	445,618	7,806	6.95
Total interest-earning assets	725,123	10,377	5.68	659,743	10,199	6.13
Cash and due from banks	9,726			9,067		
Bank premises and equipment	12,924			11,896		
Other assets	29,139			27,533		
Total non-interest earning assets	51,789			48,496		
Total assets	776,912			708,239		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
NOW accounts	158,926	212	0.53	123,265	234	0.75
Savings accounts	56,496	43	0.30	47,609	37	0.31
Money market accounts	49,339	67	0.54	41,996	78	0.74
Certificates of deposit	318,824	1,991	2.48	312,898	2,428	3.08
Total interest-bearing deposits	583,585	2,313	1.57	525,768	2,777	2.09
Other borrowed funds	53,553	444	3.29	58,959	500	3.37
Total interest-bearing liabilities	637,138	2,757	1.72	584,727	3,277	2.22

Demand deposits	67,630			58,080		
Other liabilities	7,716			8,697		
Total non-interest-bearing liabilities	75,346			66,777		
Stockholders' equity	64,428			56,735		
Total liabilities & stockholders' equity	776,912			708,239		
Net interest income		7,620			6,922	
Net interest spread (5)			3.96%			3.91%
Net interest income as a percentage						
of average interest-earning assets			4.17%			4.16%
Ratio of interest-earning assets						
to interest-bearing liabilities			1.14			1.13

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

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, 2010 and 2009:

(dollars in thousands)	For the Three Months Ended September 30 2010	2009	For the Nine Months Ended September 30 2010	2009
Interest and dividend income from investment securities and interest bearing deposits at banks (non-tax adjusted)	$ 1,988	$ 2,086	$ 5,999	$ 6,277
Tax equivalent adjustment	398	307	1,103	816
Interest and dividend income from investment securities and interest bearing deposits at banks (tax equivalent basis)	$ 2,386	$ 2,393	$ 7,102	$ 7,093
Interest and fees on loans (non-tax adjusted)	$ 7,782	$ 7,581	$ 23,268	$ 22,616
Tax equivalent adjustment	209	225	643	685
Interest and fees on loans (tax equivalent basis)	$ 7,991	$ 7,806	$ 23,911	$ 23,301
Total interest income	$ 9,770	$ 9,667	$ 29,267	$ 28,893
Total interest expense	2,757	3,277	8,698	10,074
Net interest income	7,013	6,390	20,569	18,819
Total tax equivalent adjustment	607	532	1,746	1,501