

CITIZENS HOLDING CO /MS/  
Form 10-Q  
November 09, 2012  
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**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, 2012

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: 001-15375

**CITIZENS HOLDING COMPANY**

(Exact name of registrant as specified in its charter)

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<b>MISSISSIPPI</b> (State or other jurisdiction of incorporation or organization)	<b>64-0666512</b> (IRS Employer Identification No.)
<b>521 Main Street, Philadelphia, MS</b> (Address of principal executive offices)	<b>39350</b> (Zip Code)
<b>601-656-4692</b> (Registrant's telephone number, including area code)	

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or 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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller Reporting Company	<input type="checkbox"/>

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

Number of shares outstanding of each of the issuer's classes of common stock, as of November 7, 2012:

Title	Outstanding
Common Stock, \$0.20 par value	4,861,411

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CITIZENS HOLDING COMPANY

INTERIM FINANCIAL STATEMENTS FOR QUARTER ENDED SEPTEMBER 30, 2012

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## PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (Unaudited).  
CITIZENS HOLDING COMPANY

## CONSOLIDATED STATEMENTS OF CONDITION (Unaudited)

	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$ 20,130,091	\$ 35,407,715
Interest bearing deposits with other banks	2,151,946	3,990,521
Investment securities available for sale, at fair value	398,200,446	374,507,805
Loans, net of allowance for loan losses of \$7,449,432 in 2012 and \$6,681,412 in 2011	370,750,748	382,580,529
Premises and equipment, net	19,490,631	20,278,443
Other real estate owned, net	5,004,760	4,868,653
Accrued interest receivable	4,368,970	4,445,384
Cash value of life insurance	20,926,336	20,382,063
Intangible assets, net	3,149,657	3,226,612
Other assets	3,723,886	4,257,729
<b>TOTAL ASSETS</b>	<b>\$ 847,897,471</b>	<b>\$ 853,945,454</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing demand	\$ 107,337,450	\$ 116,894,676
Interest-bearing NOW and money market accounts	211,875,266	172,585,498
Savings deposits	46,051,865	41,876,977
Certificates of deposit	251,757,698	240,980,984
<b>Total deposits</b>	<b>617,022,279</b>	<b>572,338,135</b>
Securities sold under agreement to repurchase	61,357,699	120,220,433
Federal Home Loan Bank advances	68,500,000	68,500,000
Federal funds purchased	4,700,000	
Accrued interest payable	351,463	372,374
Deferred compensation payable	5,750,575	5,085,935
Other liabilities	1,814,643	1,349,360
<b>Total liabilities</b>	<b>759,496,659</b>	<b>767,866,237</b>
<b>STOCKHOLDERS EQUITY</b>		
Common stock; \$.20 par value, 22,500,000 shares authorized, 4,861,411 shares issued and outstanding at September 30, 2012 and 4,843,911 shares issued and outstanding at December 31, 2011	972,282	968,782
Additional paid-in capital	3,620,967	3,247,208
Retained earnings	79,257,353	77,420,318
Accumulated other comprehensive income, net of applicable taxes of \$3,072,945 in 2012 and \$2,643,070 in 2011	4,550,210	4,442,909
<b>Total stockholders equity</b>	<b>88,400,812</b>	<b>86,079,217</b>

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TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 847,897,471	\$ 853,945,454
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The accompanying notes are an integral part of these financial statements.

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## CITIZENS HOLDING COMPANY

## CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>INTEREST INCOME</b>				
Loans, including fees	\$ 5,633,206	\$ 6,306,980	\$ 17,643,633	\$ 19,254,589
Investment securities	2,609,503	3,101,121	8,483,553	8,924,368
Other interest	32,641	14,967	50,322	33,234
<b>Total interest income</b>	<b>8,275,350</b>	<b>9,423,068</b>	<b>26,177,508</b>	<b>28,212,191</b>
<b>INTEREST EXPENSE</b>				
Deposits	668,407	757,177	2,096,841	2,446,794
Other borrowed funds	728,659	833,020	2,268,067	2,592,724
<b>Total interest expense</b>	<b>1,397,066</b>	<b>1,590,197</b>	<b>4,364,908</b>	<b>5,039,518</b>
<b>NET INTEREST INCOME</b>	<b>6,878,284</b>	<b>7,832,871</b>	<b>21,812,600</b>	<b>23,172,673</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>462,684</b>	<b>1,659,873</b>	<b>1,328,461</b>	<b>2,586,707</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>6,415,600</b>	<b>6,172,998</b>	<b>20,484,139</b>	<b>20,585,966</b>
<b>OTHER INCOME</b>				
Service charges on deposit accounts	966,149	999,478	2,711,719	2,729,861
Other service charges and fees	509,443	474,171	1,375,512	1,303,304
Other income	364,973	973,163	1,000,089	1,514,508
<b>Total other income</b>	<b>1,840,565</b>	<b>2,446,812</b>	<b>5,087,320</b>	<b>5,547,673</b>
<b>OTHER EXPENSES</b>				
Salaries and employee benefits	3,414,811	3,518,464	10,448,471	10,562,176
Occupancy expense	1,147,917	1,081,113	3,277,082	3,188,602
Other operating expense	1,710,148	2,100,350	5,631,591	5,595,469
<b>Total other expenses</b>	<b>6,272,876</b>	<b>6,699,927</b>	<b>19,357,144</b>	<b>19,346,247</b>
<b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>	<b>1,983,289</b>	<b>1,919,883</b>	<b>6,214,315</b>	<b>6,787,392</b>
<b>PROVISION FOR INCOME TAXES</b>	<b>354,247</b>	<b>297,525</b>	<b>1,170,509</b>	<b>1,355,876</b>
<b>NET INCOME</b>	<b>\$ 1,629,042</b>	<b>\$ 1,622,358</b>	<b>\$ 5,043,806</b>	<b>\$ 5,431,516</b>
<b>NET INCOME PER SHARE</b>				
-Basic	\$ 0.34	\$ 0.33	\$ 1.04	\$ 1.12
-Diluted	\$ 0.33	\$ 0.33	\$ 1.04	\$ 1.12
<b>DIVIDENDS PAID PER SHARE</b>	<b>\$ 0.22</b>	<b>\$ 0.22</b>	<b>\$ 0.66</b>	<b>\$ 0.66</b>

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



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## CITIZENS HOLDING COMPANY

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$ 1,629,042	\$ 1,622,358	\$ 5,043,806	\$ 5,431,516
Other comprehensive income				
Unrealized holding gains	(975,371)	3,560,984	214,860	11,912,077
Income tax effect	363,813	(1,328,247)	(80,143)	(4,443,205)
	(611,558)	2,232,737	134,717	7,468,872
Reclassification adjustment for gains included in net income	(5,972)	(636,542)	(43,725)	(642,331)
Income tax effect	2,227	237,430	16,309	239,589
	(3,745)	(399,112)	(27,416)	(402,742)
Total other comprehensive income	(615,303)	1,833,625	107,301	7,066,130
Comprehensive income	\$ 1,013,739	\$ 3,455,983	\$ 5,151,107	\$ 12,497,646

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



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## CITIZENS HOLDING COMPANY

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Nine Months	
	Ended September 30,	
	2012	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net cash provided by operating activities	\$ 8,968,505	\$ 9,650,546
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from maturities and calls of securities available for sale	220,117,006	138,683,906
Proceeds from sales of securities available for sale		19,791,797
Purchases of investment securities available for sale	(244,228,754)	(138,881,327)
Purchases of bank premises and equipment	(70,332)	(967,408)
Increase(decrease) in interest bearing deposits with other banks	1,838,575	(33,708,589)
Purchase of Federal Home Loan Bank Stock	(282,700)	(108,000)
Redemption of Federal Home Loan Bank Stock	442,800	
Proceeds from sale of other real estate	1,296,551	466,095
Net decrease in loans	9,068,662	12,350,775
Net cash provided by (used by) investing activities	(11,818,192)	(2,372,751)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	44,684,143	29,819,741
Net change in securities sold under agreement to repurchase	(58,862,734)	(12,990,464)
Proceeds from exercising stock options	257,425	63,385
Increase in Federal Home Loan Bank advances		(15,900,000)
(Decrease) increase in federal funds purchased	4,700,000	(2,500,000)
Payment of dividends	(3,206,771)	(3,195,991)
Net cash provided by financing activities	(12,427,937)	(4,703,329)
Net increase in cash and due from banks	(15,277,624)	2,574,466
Cash and due from banks, beginning of period	35,407,715	16,963,393
Cash and due from banks, end of period	\$ 20,130,091	\$ 19,537,859

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

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CITIZENS HOLDING COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of and for the nine months ended September 30, 2012

(Unaudited)

**Note 1. Basis of Presentation**

These interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). However, these financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. The interim consolidated financial statements are unaudited and reflect all adjustments and reclassifications, which, in the opinion of management, are necessary for a fair presentation of the results of operations and financial condition as of and for the interim periods presented. All adjustments and reclassifications are of a normal and recurring nature. Results for the period ended September 30, 2012, are not necessarily indicative of the results that may be expected for any other interim periods or for the year as a whole.

The interim consolidated financial statements of Citizens Holding Company include the accounts of its wholly-owned subsidiary, The Citizens Bank of Philadelphia (the Bank and collectively with Citizens Holding Company, the Corporation). All significant intercompany transactions have been eliminated in consolidation.

For further information and significant accounting policies of the Corporation, see the Notes to Consolidated Financial Statements of Citizens Holding Company included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011, filed with the Securities and Exchange Commission on March 14, 2012.

**Note 2. Commitments and Contingent Liabilities**

In the ordinary course of business, the Corporation enters into commitments to extend credit to its customers. The unused portion of these commitments is not reflected in the accompanying financial statements. As of September 30, 2012, the Corporation had entered into loan commitments with certain customers with an aggregate unused balance of \$33,218,063 compared to an aggregate unused balance of \$37,703,387 at December 31, 2011. There were \$2,892,830 of letters of credit outstanding at September 30, 2012 and \$3,113,225 at December 31, 2011. The fair value of such contracts is not considered material because letters of credit and loan commitments often are not used in their entirety, if at all, before they expire. The balances of such letters and commitments should not be used to project actual future liquidity requirements. However, the Corporation does incorporate expectations about the level of draws under its credit-related commitments into its asset and liability management program.

The Corporation is a party to lawsuits and other claims that arise in the ordinary course of business, all of which are being vigorously contested. In the regular course of business, management evaluates estimated losses or costs related to litigation, and provisions are made for anticipated losses whenever management believes that such losses are probable and can be reasonably estimated. At the present time, management believes, based on the advice of legal counsel, that the final resolution of pending legal proceedings will not have a material impact on the Corporation's consolidated financial condition or results of operations.

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Net income per share - basic has been computed based on the weighted average number of shares outstanding during each period. Net income per share - diluted has been computed based on the weighted average number of shares outstanding during each period plus the dilutive effect of outstanding stock options using the treasury stock method. Earnings per share was computed as follows:

	For the Three Months		For the Nine Months	
	Ended September 30, 2012	2011	Ended September 30, 2012	2011
Basic weighted average shares outstanding	4,861,411	4,843,911	4,856,584	4,841,829
Dilutive effect of granted options	5,628	10,364	8,493	7,683
Diluted weighted average shares outstanding	4,867,039	4,854,275	4,865,077	4,849,512
Net income	\$ 1,629,042	\$ 1,622,358	\$ 5,043,806	\$ 5,431,516
Net income per share-basic	\$ 0.34	\$ 0.33	\$ 1.04	\$ 1.12
Net income per share-diluted	\$ 0.33	\$ 0.33	\$ 1.04	\$ 1.12

**Note 4. Stock Option Plan**

At September 30, 2012, the Corporation had one stock-based compensation plan, which is the 1999 Directors' Stock Compensation Plan (the Directors' Plan). Prior to its expiration, the Corporation also had the 1999 Employees' Long-Term Incentive Plan, or the Employees' Plan.

On April 25, 2012, the non-management members of the Board of Directors were granted a total of 13,500 options as specified in the Directors' Plan. These options were granted at an exercise price of \$18.76 per option, which was the closing price of Citizens Holding Company stock on that day. These options are first exercisable on October 26, 2012, and must be exercised no later than April 25, 2022.

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The fair value of each option granted is estimated on the date of the grant using the Black-Scholes option-pricing model. The following assumptions were used in estimating the fair value of the options granted to the directors in the second quarter of 2012:

Assumption	Directors
Dividend Yield	4.70%
Risk-Free Interest Rate	0.78%
Expected Life	8.2 years
Expected Volatility	78.29%
Calculated Value per Option	\$ 8.88
Forfeitures	0.00%

Using the Black-Scholes option-pricing model with the foregoing assumptions, it was determined that the cost of options granted under the Directors Plan on April 25, 2012 was \$119,834 and should be recognized as an expense of \$19,972 per month over the six-month requisite service period, beginning on April 25, 2012. This was recorded as salary expense with a credit to paid-in capital. A deferred tax on these options was recorded in the aggregate amount of \$44,698, or \$7,450 per month, over the six-month requisite service period, beginning on April 25, 2012.

The following table below is a summary of the stock option activity for the nine months ended September 30, 2012.

	Directors Plan Number of Shares	Weighted Average Exercise Price	Employees Plan Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 2011	102,000	\$ 21.00	135,500	\$ 19.96
Granted	13,500	18.76		
Exercised	(3,000)	15.00	(14,500)	14.65
Expired	(1,500)	15.00	(13,000)	18.09
Outstanding at September 30, 2012	111,000	\$ 20.97	108,000	\$ 20.90

The intrinsic value of options granted under the Directors Plan at September 30, 2012, was \$42,900 and the intrinsic value of options granted under the Employees Plan at September 30, 2012, was \$79,735 for a total intrinsic value at September 30, 2012, of \$122,635.

**Note 5. Income Taxes**

The income tax topic of the ASC defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. This topic also provides guidance on the derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties, and includes guidance concerning accounting for income tax uncertainties in interim periods. As of September 30, 2012, the Corporation had no unrecognized tax benefits related to federal and state income tax matters. Therefore, the Corporation does not anticipate any material increase or decrease in the effective tax rate during 2012 relative to any tax positions taken. It is the Corporation's policy to recognize interest and/or penalties related to income tax matters in income tax expense.

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The Corporation files a consolidated United States federal income tax return. The Corporation is currently open to audit under the statute of limitations by the Internal Revenue Service for all tax years after 2009. The Corporation consolidated state income tax returns are also open to audit under the statute of limitations for the same period.

**Note 6. Loans**

The composition of net loans at September 30, 2012 and December 31, 2011 is as follows:

	September 30, 2012	December 31, 2011
	(In Thousands)	
<b>Real Estate:</b>		
Land Development and Construction	\$ 11,280	\$ 13,480
Farmland	32,986	35,912
1-4 Family Mortgages	119,297	133,987
Commercial Real Estate	131,906	129,387
<b>Total Real Estate Loans</b>	<b>295,469</b>	<b>312,766</b>
<b>Business Loans:</b>		
Commercial and Industrial Loans	50,802	36,581
Farm Production and Other Farm Loans	1,515	1,579
<b>Total Business Loans</b>	<b>52,317</b>	<b>38,160</b>
<b>Consumer Loans:</b>		
Credit Cards	976	995
Other Consumer Loans	29,680	37,545
<b>Total Consumer Loans</b>	<b>30,656</b>	<b>38,540</b>
<b>Total Gross Loans</b>	<b>378,442</b>	<b>389,466</b>
Unearned income	(242)	(204)
Allowance for loan losses	(7,449)	(6,681)
<b>Loans, net</b>	<b>\$ 370,751</b>	<b>\$ 382,581</b>

Loans are considered to be past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status, when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether such loans are considered past due. When interest accruals are discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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Period-end non-accrual loans, segregated by class of loans, were as follows:

	September 30, 2012		December 31, 2011	
	(in thousands)			
<b>Real Estate:</b>				
Land Development and Construction	\$	234	\$	1,134
Farmland		843		641
1-4 Family Mortgages		2,525		1,966
Commercial Real Estate		10,471		6,818
<b>Total Real Estate Loans</b>		<b>14,073</b>		<b>10,559</b>
<b>Business Loans:</b>				
Commercial and Industrial Loans		174		284
Farm Production and Other Farm Loans		5		21
<b>Total Business Loans</b>		<b>179</b>		<b>305</b>
<b>Consumer Loans:</b>				
Other Consumer Loans		248		435
<b>Total Consumer Loans</b>		<b>248</b>		<b>435</b>
<b>Total Non-Accrual Loans</b>	<b>\$</b>	<b>14,500</b>	<b>\$</b>	<b>11,299</b>

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An aging analysis of past due loans, segregated by class of loans, as of September 30, 2012, was as follows (in thousands):

	Loans 30-89 Days Past Due	Loans 90 or more Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or more Days Past Due
<b>Real Estate:</b>						
Land Development and Construction	\$ 77	\$	\$ 77	\$ 11,203	\$ 11,280	\$
Farmland	552	347	899	32,087	32,986	
1-4 Family Mortgages	4,625	897	5,522	113,775	119,297	49
Commercial Real Estate	3,030	4,672	7,702	124,204	131,906	
<b>Total Real Estate Loans</b>	<b>8,284</b>	<b>5,916</b>	<b>14,200</b>	<b>281,269</b>	<b>295,469</b>	<b>49</b>
<b>Business Loans:</b>						
Commercial and Industrial Loans	420	8	428	50,374	50,802	
Farm Production and Other Farm Loans	23		23	1,492	1,515	
<b>Total Business Loans</b>	<b>443</b>	<b>8</b>	<b>451</b>	<b>51,866</b>	<b>52,317</b>	
<b>Consumer Loans:</b>						
Credit Cards	51	28	79	897	976	28
Other Consumer Loans	1,300	58	1,358	28,322	29,680	43
<b>Total Consumer Loans</b>	<b>1,351</b>	<b>86</b>	<b>1,437</b>	<b>29,219</b>	<b>30,656</b>	<b>71</b>
<b>Total Loans</b>	<b>\$ 10,078</b>	<b>\$ 6,010</b>	<b>\$ 16,088</b>	<b>\$ 362,354</b>	<b>\$ 378,442</b>	<b>\$ 120</b>

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An aging analysis of past due loans, segregated by class of loans, as of December 31, 2011 was as follows (in thousands):

	Loans 30-89 Days Past Due	Loans 90 or more Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or more Days Past Due
<b>Real Estate:</b>						
Land Development and Construction	\$ 30	\$ 562	\$ 592	\$ 12,888	\$ 13,480	\$ 39
Farmland	1,061	139	1,200	34,712	35,912	
1-4 Family Mortgages	5,774	822	6,596	127,391	133,987	80
Commercial Real Estate	4,941	4,855	9,796	119,591	129,387	109
<b>Total Real Estate Loans</b>	<b>11,806</b>	<b>6,378</b>	<b>18,184</b>	<b>294,582</b>	<b>312,766</b>	<b>228</b>
<b>Business Loans:</b>						
Commercial and Industrial Loans	294	99	393	36,188	36,581	
Farm Production and Other Farm Loans	13	6	19	1,560	1,579	
<b>Total Business Loans</b>	<b>307</b>	<b>105</b>	<b>412</b>	<b>37,748</b>	<b>38,160</b>	
<b>Consumer Loans:</b>						
Credit Cards	20	17	37	958	995	17
Other Consumer Loans	1,858	252	2,110	35,435	37,545	24
<b>Total Consumer Loans</b>	<b>1,878</b>	<b>269</b>	<b>2,147</b>	<b>36,393</b>	<b>38,540</b>	<b>41</b>
<b>Total Loans</b>	<b>\$ 13,991</b>	<b>\$ 6,752</b>	<b>\$ 20,743</b>	<b>\$ 368,723</b>	<b>\$ 389,466</b>	<b>\$ 269</b>

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all the amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. In determining which loans to evaluate for impairment, management looks at past due loans, bankruptcy filing and any situation that might lend itself to cause a borrower to be unable to repay the loan according to the original contract terms. If a loan is determined to be impaired and the collateral is deemed to be insufficient to fully repay the loan, a specific reserve will be established. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans or portions thereof, are charged-off when deemed uncollectible.



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Impaired loans as of September 30, 2012 and December 31, 2011, by class of loans, are as follows (in thousands):

	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
September 30, 2012						
<b>Real Estate:</b>						
Land Development and Construction	\$ 234	\$ 106	\$ 128	\$ 234	\$ 117	\$ 356
Farmland	843	701	142	843	24	700
1-4 Family Mortgages	2,525	1,732	793	2,525	220	2,472
Commercial Real Estate	10,471	4,846	5,625	10,471	1,326	8,750
<b>Total Real Estate Loans</b>	<b>14,073</b>	<b>7,385</b>	<b>6,688</b>	<b>14,073</b>	<b>1,687</b>	<b>12,278</b>
<b>Business Loans:</b>						
Commercial and Industrial Loans	174	76	98	174	57	206
Farm Production and Other Farm Loans	5	5		5		9
<b>Total Business Loans</b>	<b>179</b>	<b>81</b>	<b>98</b>	<b>179</b>	<b>57</b>	<b>215</b>
<b>Consumer Loans:</b>						
Other Consumer Loans	248	248		248		277
<b>Total Consumer Loans</b>	<b>248</b>	<b>248</b>		<b>248</b>		<b>277</b>
<b>Total Loans</b>	<b>\$ 14,500</b>	<b>\$ 7,714</b>	<b>\$ 6,786</b>	<b>\$ 14,500</b>	<b>\$ 1,744</b>	<b>\$ 12,770</b>

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December 31, 2011	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
<b>Real Estate:</b>						
Land Development and Construction	\$ 1,134	\$ 992	\$ 142	\$ 1,134	\$ 134	\$ 883
Farmland	641	492	149	641	24	588
1-4 Family Mortgages	2,066	1,297	769	2,066	216	1,933
Commercial Real Estate	6,818	5,042	1,776	6,818	736	6,896
<b>Total Real Estate Loans</b>	<b>10,659</b>	<b>7,823</b>	<b>2,836</b>	<b>10,659</b>	<b>1,110</b>	<b>10,300</b>
<b>Business Loans:</b>						
Commercial and Industrial Loans	284	163	121	284	57	860
Farm Production and Other Farm Loans	21	21		21		19
<b>Total Business Loans</b>	<b>305</b>	<b>184</b>	<b>121</b>	<b>305</b>	<b>57</b>	<b>879</b>
<b>Consumer Loans:</b>						
Other Consumer Loans	435	430	5	435		321
<b>Total Consumer Loans</b>	<b>435</b>	<b>430</b>	<b>5</b>	<b>435</b>		<b>321</b>
<b>Total Loans</b>	<b>\$ 11,399</b>	<b>\$ 8,437</b>	<b>\$ 2,962</b>	<b>\$ 11,399</b>	<b>\$ 1,167</b>	<b>\$ 11,500</b>

The Corporation utilizes a risk grading matrix to assign a risk grade to each of its loans when originated and is updated as factors related to the strength of the loan changes. Loans are graded on a scale of 1 to 9. A description of the general characteristics of the 9 risk grades is as follows.

**Grade 1. MINIMAL RISK** - These loans are without loss exposure to the Corporation. This classification is reserved for only the best, well secured loans to borrowers with significant capital strength, low leverage, stable earnings and growth and other readily available financing alternatives. This type of loan would also include loans secured by a program of the government.

**Grade 2. MODEST RISK** - These loans include borrowers with solid credit quality and moderate risk of loss. These loans may be fully secured by certificates of deposit with another reputable financial institution, or secured by readily marketable securities with acceptable margins.

**Grade 3. AVERAGE RISK** - This is the rating assigned to most of the loans held by the Corporation. This includes loans with average loss exposure and average overall quality. These loans should liquidate through possessing adequate collateral and adequate earnings of the borrower. In addition, these loans are properly documented and are in accordance with all aspects of the current loan policy.

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Grade 4. ACCEPTABLE RISK - Borrower generates sufficient cash flow to fund debt service but most working asset and capital expansion needs are provided from external sources. Profitability and key balance sheet ratios are usually close to peers but one or more may be higher than peers.

Grade 5. MANAGEMENT ATTENTION - Borrower has significant weaknesses resulting from performance trends or management concerns. The financial condition of the borrower has taken a negative turn and may be temporarily strained. Cash flow is weak but cash reserves remain adequate to meet debt service. Management weakness is evident.

Grade 6. OTHER LOANS ESPECIALLY MENTIONED (OLEM) - Loans in this category are fundamentally sound but possess some weaknesses. OLEM loans have potential weaknesses which may, if not checked or corrected, weaken the asset or inadequately protect the bank's credit position at some future date. These loans have an identifiable weakness in credit, collateral, or repayment ability but there is no expectation of loss.

Grade 7. SUBSTANDARD ASSETS - Assets classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets classified as substandard must have a well-defined weakness based upon objective evidence. Assets classified as substandard are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. The possibility that liquidation would not be timely requires a substandard classification even if there is little likelihood of total loss.

Grade 8. DOUBTFUL - A loan classified as doubtful has all the weaknesses of a substandard classification and the added characteristic that the weakness makes collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable or improbable. The possibility of loss is extremely high, but because of certain important and reasonable specific pending factors which may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined. A doubtful classification could reflect the fact that the primary source of repayment is gone and serious doubt exists as to the quality of a secondary source of repayment.

Grade 9. LOSS - Loans classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future. Also included in this classification is the defined loss portion of loans rated substandard assets and doubtful assets.

These internally assigned grades are updated on a continual basis throughout the course of the year and represent management's most updated judgment regarding grades at September 30, 2012.

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The following table details the amount of gross loans by loan grade and class as of September 30, 2012 (in thousands):

	Grades	Satisfactory 1, 2, 3, 4	Special Mention 5,6	Substandard 7	Doubtful 8	Loss 9	Total Loans
<b>Real Estate:</b>							
Land Development and Construction		\$ 8,946	\$ 1,906	\$ 428	\$	\$	\$ 11,280
Farmland		28,574	2,797	1,615			32,986
1-4 Family Mortgages		100,826	5,783	12,688			119,297
Commercial Real Estate		108,248	6,865	16,793			131,906
<b>Total Real Estate Loans</b>		<b>246,594</b>	<b>17,351</b>	<b>31,524</b>			<b>295,469</b>
<b>Business Loans:</b>							
Commercial and Industrial Loans		36,686	1,108	675	30		38,499
Farm Production and Other Farm Loans		1,433	29	53			1,515
<b>Total Business Loans</b>		<b>38,119</b>	<b>1,137</b>	<b>728</b>	<b>30</b>		<b>40,014</b>
<b>Consumer Loans:</b>							
Credit Cards		948		28			976
Other Consumer Loans		40,528	314	1,112	29		41,983
<b>Total Consumer Loans</b>		<b>41,476</b>	<b>314</b>	<b>1,140</b>	<b>29</b>		<b>42,959</b>
<b>Total Loans</b>		<b>\$ 324,869</b>	<b>\$ 18,802</b>	<b>\$ 33,392</b>	<b>\$ 59</b>	<b>\$</b>	<b>\$ 378,442</b>

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The following table details the amount of gross loans by loan grade and class as of December 31, 2011 (in thousands):

	Grades	Satisfactory 1, 2, 3,4	Mention 5,6	Substandard 7	Doubtful 8	Loss 9	Total Loans
<b>Real Estate:</b>							
Land Development and Construction		\$ 9,647	\$ 2,290	\$ 1,481	\$	\$ 62	\$ 13,480
Farmland		31,405	3,043	1,464			35,912
1-4 Family Mortgages		115,365	5,784	12,811	27		133,987
Commercial Real Estate		108,347	7,188	13,852			129,387
<b>Total Real Estate Loans</b>		<b>264,764</b>	<b>18,305</b>	<b>29,608</b>	<b>27</b>	<b>62</b>	<b>312,766</b>
<b>Business Loans:</b>							
Commercial and Industrial Loans		27,970	7,712	863	36		36,581
Farm Production and Other Farm Loans		1,481	8	90			1,579
<b>Total Business Loans</b>		<b>29,451</b>	<b>7,720</b>	<b>953</b>	<b>36</b>		<b>38,160</b>
<b>Consumer Loans:</b>							
Credit Cards		978		17			995
Other Consumer Loans		35,859	325	1,304	53	4	37,545
<b>Total Consumer Loans</b>		<b>36,837</b>	<b>325</b>	<b>1,321</b>	<b>53</b>	<b>4</b>	<b>38,540</b>
<b>Total Loans</b>		<b>\$ 331,052</b>	<b>\$ 26,350</b>	<b>\$ 31,882</b>	<b>\$ 116</b>	<b>\$ 66</b>	<b>\$ 389,466</b>

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio.

The allowance on the majority of the loan portfolio is calculated using a historical chargeoff percentage applied to the current loan balances by loan segment. This historical period is the average of the previous 5 years with the most current years weighted to show the effect of the most recent chargeoff activity. This percentage is also adjusted for economic factors such as local unemployment and general business conditions, both local and nationwide.

The group of loans that are considered to be impaired are individually evaluated for possible loss and a specific reserve is established to cover any loss contingency. Loans that are determined to be a loss with no benefit of remaining in the portfolio are charged off to the allowance. These specific reserves are reviewed periodically for continued impairment and adequacy of the specific reserve and adjusted when necessary.

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The following table details activity in the allowance for possible loan losses by portfolio segment for the nine months ended September 30, 2012:

<b>September 30, 2012</b>	Real Estate	Business Loans	Consumer	Total
Beginning Balance, January 1, 2012	\$ 4,176,475	\$ 1,672,467	\$ 832,470	\$ 6,681,412
Provision for possible loan losses	1,204,314	15,456	108,691	1,328,461
Chargeoffs	511,610	55,260	200,144	767,014
Recoveries	49,440	50,332	106,801	206,573
<b>Net Chargeoffs</b>	<b>462,170</b>	<b>4,928</b>	<b>93,343</b>	<b>560,441</b>
Ending Balance	\$ 4,918,619	\$ 1,682,995	\$ 847,818	\$ 7,449,432
<b>Period end allowance allocated to:</b>				
Loans individually evaluated for impairment	\$ 1,686,862	\$ 57,325	\$	\$ 1,744,187
Loans collectively evaluated for impairment	3,231,757	1,625,670	847,818	5,705,245
Ending Balance, September 30, 2012	\$ 4,918,619	\$ 1,682,995	\$ 847,818	\$ 7,449,432

Activity in the allowance for possible loan losses for the nine months ended September 30, 2011 was as follows:

	<b>September 30, 2011</b>
Balance, beginning of period	\$ 6,379,070
Provision for possible loan losses	2,586,707
Chargeoffs	(1,658,080)
Recoveries	96,721
<b>Balance, end of period</b>	<b>\$ 7,404,418</b>

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The Corporation's recorded investment in loans as of September 30, 2012 and December 31, 2011 related to each balance in the allowance for possible loan losses by portfolio segment and disaggregated on the basis of the Corporation's impairment methodology was as follows (in thousands):

	Real Estate	Business Loans	Consumer	Total
<b>September 30, 2012</b>				
Loans individually evaluated for specific impairment	\$ 14,073	\$ 179	\$ 248	\$ 14,500
Loans collectively evaluated for general impairment	281,396	39,835	42,711	363,942
	\$ 295,469	\$ 40,014	\$ 42,959	\$ 378,442
<b>December 31, 2011</b>				
Loans individually evaluated for specific impairment	\$ 10,659	\$ 305	\$ 435	\$ 11,399
Loans collectively evaluated for general impairment	302,107	37,855	38,105	378,067
	\$ 312,766	\$ 38,160	\$ 38,540	\$ 389,466

**Note 7. Recent Accounting Pronouncements**

In September 2011, FASB issued an update to ASC Topic 350 to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. This update is effective for annual and interim impairment tests beginning after December 15, 2011, and has not had a significant impact on the Corporation's financial statements as it related to disclosures made herein.

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The fair value topic of the ASC establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. This topic clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. This topic also requires disclosure about how fair value was determined for assets and liabilities and establishes a hierarchy for which these assets and liabilities must be grouped, based on significant levels of inputs as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities;
- Level 2 Quoted prices in active markets for similar assets and liabilities and inputs that are observable for the asset or liability; or
- Level 3 Unobservable inputs, such as discounted cash flow models or valuations.

The determination of where assets and liabilities fall within this hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following table presents assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2012:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Totals
Securities available for sale				
Obligations of U. S. Government Agencies	\$	\$ 230,111,488	\$	\$ 230,111,488
Mortgage-backed Securities		42,787,673		42,787,673
State, county and municipal obligations		118,719,401		118,719,401
Other investments			2,849,684	2,849,684
Total	\$	\$ 391,618,562	\$ 2,849,684	\$ 394,468,246



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The following table presents assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2011:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Totals
Securities available for sale				
Obligations of U. S. Government Agencies	\$	\$ 234,938,488	\$	\$ 234,938,488
Mortgage-backed Securities		35,117,858		35,117,858
State, county and municipal obligations		102,422,164		102,422,164
Other investments			2,029,295	2,029,295
Total	\$	\$ 372,478,510	\$ 2,029,295	\$ 374,507,805

The following table reports the activity for 2012 in assets measured at fair value on a recurring basis using significant unobservable inputs.

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Structured Financial Product
Balance at January 1, 2012	\$ 2,029,295
Unrealized gains included in other comprehensive income	820,389
Balance at September 30, 2012	\$ 2,849,684

The Corporation recorded no gains or losses in earnings for the period that were attributable to the change in unrealized gains or losses relating to assets still held at the reporting date.

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For assets measured at fair value on a nonrecurring basis during 2012 that were still held in the balance sheet at September 30, 2012, the following table provides the hierarchy level and the fair value of the related assets:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Totals
Impaired loans	\$	\$	\$ 4,100,152	\$ 4,100,152
Other real estate owned			688,091	688,091
<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$ 4,788,243</b>	<b>\$ 4,788,243</b>

For assets measured at fair value on a nonrecurring basis during 2011 that were still held in the balance sheet at December 31, 2011, the following table provides the hierarchy level and the fair value of the related assets:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Totals
Impaired loans	\$	\$	\$ 505,585	\$ 505,585
Other real estate owned			3,056,902	3,056,902
<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$ 3,562,487</b>	<b>\$ 3,562,487</b>

Impaired loans with a carrying value of \$4,828,328 and \$682,517 had an allocated allowance for loan losses of \$728,176 and \$176,932 at September 30, 2012 and December 31, 2011, respectively. The allocated allowance is based on the carrying value of the impaired loan and the fair value of the underlying collateral less estimated costs to sell.

Other real estate owned ( OREO ) acquired during the nine-month period ended September 30, 2012, and recorded at fair value, less costs to sell, was \$1,432,658, of which \$200,983 was acquired and sold during this period. There have been no writedowns during the period on OREO previously acquired and still held. OREO acquired during 2011 and recorded at fair value, less costs to sell, was \$2,503,659. Additional writedowns during 2011 on OREO acquired in previous years was \$216,000 on 10 properties valued at \$553,243.

The financial instruments topic of the ASC requires disclosure of financial instruments fair values, as well as the methodology and significant assumptions used in estimating fair values. In

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cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. The financial instruments topic of the ASC excludes certain financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Corporation and may not be indicative of amounts that might ultimately be realized upon disposition or settlement of those assets and liabilities.

The following represents the carrying value and estimated fair value of the Corporation's financial instruments at September 30, 2012, and December 31, 2011:

	September 30, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets</b>				
Cash and due from banks	\$ 20,130,091	\$ 20,130,091	\$ 35,407,715	\$ 35,407,715
Interest bearing deposits with banks	2,151,946	2,151,946	3,990,521	3,990,521
Securities available-for-sale	398,200,446	398,200,446	374,507,805	374,507,805
Net loans	370,750,748	371,139,705	382,580,529	382,174,094
<b>Financial liabilities</b>				
Deposits	\$ 617,022,279	\$ 617,282,935	\$ 572,338,135	\$ 572,388,706
Federal Home Loan Bank advances	68,500,000	71,353,147	68,500,000	71,950,022
Securities Sold under agreement to repurchase	61,357,699	61,357,699	120,220,433	120,220,433

The fair value estimates, methods and assumptions used by the Corporation in estimating its fair value disclosures for financial statements were as follows:

**Cash and Due from Banks and Interest Bearing Deposits with Banks**

The carrying amounts reported in the balance sheet for these instruments approximate fair value because of their immediate and shorter-term maturities, which are considered to be three months or less when purchased.

**Securities Available-for-Sale**

Fair values for investment securities are based on quoted market prices, when available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. When neither quoted prices nor comparable instruments are available, unobservable inputs are needed to form an expected future cash flow analysis to establish fair values. Level 2 securities include debt securities such as obligations of United States government agencies and corporations, mortgage-backed securities and state, county and municipal bonds. Level 3 securities consist of a pooled trust preferred security.

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### Net Loans

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (i.e., commercial real estate and rental property mortgage loans, commercial and industrial loans, financial institution loans, and agricultural loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

### Deposits

The fair values for demand deposits, NOW and money market accounts and savings accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and time deposits approximate their fair values at the reporting date. Fair values for fixed-rate time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

### Securities Sold Under Agreement to Repurchase

Due to the short term nature of these instruments, which is considered to be three months or less, the carrying amount is equal to the fair value.

### Federal Home Loan Bank (FHLB) Borrowings

The fair value of FHLB advances is based on discounted cash flow analysis.

### Off-Balance Sheet Instruments

The fair value of commitments to extend credit and letters of credit are estimated using fees currently charged to enter into similar agreements. The fees associated with these financial instruments are not material.

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CITIZENS HOLDING COMPANY

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.  
FORWARD LOOKING STATEMENTS

In addition to historical information, this report contains statements which constitute forward-looking statements and information within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are based on management's beliefs, plans, expectations and assumptions and on information currently available to management. The words "may," "should," "expect," "anticipate," "intend," "plan," "continue," "believe," "seek," "estimate" and similar expressions used in this report that do not refer to facts are intended to identify forward-looking statements. These statements appear in a number of places in this report, including, but not limited to, statements found in Item 1, "Notes to Consolidated Financial Statements" and in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations." The Corporation notes that a variety of factors could cause the actual results or experience to differ materially from the anticipated results or other expectations described or implied by such forward-looking statements. The risks and uncertainties that may affect the operation, performance, development and results of the Corporation's business include, but are not limited to, the following: (a) the risk of adverse changes in business conditions in the banking industry generally and in the specific markets in which the Corporation operates; (b) changes in the legislative and regulatory environment that negatively impact the Corporation through increased operating expenses; (c) increased competition from other financial institutions; (d) the impact of technological advances; (e) expectations about the movement of interest rates, including actions that may be taken by the Federal Reserve Board in response to changing economic conditions; (f) changes in asset quality and loan demand; (g) expectations about overall economic strength and the performance of the economies in the Corporation's market area; and (h) other risks detailed from time to time in the Corporation's filings with the Securities and Exchange Commission. The Corporation does not undertake any obligation to update or revise any forward-looking statements subsequent to the date on which they are made.

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Management's discussion and analysis is intended to provide greater insight into the results of operations and the financial condition of Citizens Holding Company and its wholly owned subsidiary, The Citizens Bank of Philadelphia (the Bank, and collectively with Citizens Holding Company, the Corporation). The following discussion should be read in conjunction with the consolidated financial statements and notes appearing elsewhere in this report.

### LIQUIDITY

The Corporation has an asset and liability management program that assists management in maintaining net interest margins during times of both rising and falling interest rates and in maintaining sufficient liquidity. A measurement of liquidity is the ratio of net deposits and short-term liabilities divided by the sum of net cash, short-term investments and marketable assets. This measurement for liquidity of the Corporation at September 30, 2012, was 41.19% and at December 31, 2011, was 29.32%. Liquidity increased due to the amount of investment securities that were called and not reinvested at September 30, 2012. Management believes it maintains adequate liquidity for the Corporation's current needs.

The Corporation's primary source of liquidity is customer deposits, which were \$617,022,279 at September 30, 2012, and \$572,338,135 at December 31, 2011. Other sources of liquidity include investment securities, the Corporation's line of credit with the Federal Home Loan Bank (FHLB) and federal funds lines with correspondent banks. The Corporation had \$398,200,446 invested in investment securities at September 30, 2012, and \$374,507,805 at December 31, 2011. The Corporation also had \$2,151,946 in interest bearing deposits at other banks at September 30, 2012 and \$3,990,521 at December 31, 2011. The Corporation had secured and unsecured federal funds lines with correspondent banks in the amount of \$37,500,000 at September 30, 2012 and December 31, 2011. In addition, the Corporation has the ability to draw on its line of credit with the FHLB. At September 30, 2012, the Corporation had unused and available \$98,586,193 of its line of credit with the FHLB and at December 31, 2011, the Corporation had unused and available \$126,473,758 of its line of credit with the FHLB. The decrease in the amount available under the Corporation's line of credit with the FHLB from the end of 2011 to September 30, 2012, was the result of a reduction in the amount of loans eligible for the collateral pool. The Corporation had \$4,700,000 in federal funds purchased as of September 30, 2012 and no federal funds purchased at December 31, 2011. The Corporation usually purchases funds from correspondent banks on a temporary basis to meet short term funding needs.

When the Corporation has more funds than it needs for its reserve requirements or short-term liquidity needs, the Corporation increases its investment portfolio, increases the balances in interest bearing due from accounts or sells federal funds. It is management's policy to maintain an adequate portion of its portfolio of assets and liabilities on a short-term basis to insure rate flexibility and to meet loan funding and liquidity needs. When deposits decline or do not grow sufficiently to fund loan demand, management will seek funding either through federal funds purchased or advances from the FHLB.

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## CAPITAL RESOURCES

The total stockholders' equity was \$88,400,812 at September 30, 2012, as compared to \$86,079,217 at December 31, 2011. The reason for the increase in stockholders' equity was net earnings in excess of dividends paid and the increase in the investment securities market value adjustment due to an increase in the market value of the Corporation's investment portfolio. This market value increase was due to general market conditions, specifically the increase in medium term interest rates, which caused an increase in the market price of the investment portfolio.

Cash dividends in the amount of \$3,206,771, or \$0.66 per share, have been paid in 2012 as of the end of the third quarter 2012.

Quantitative measures established by federal regulations to ensure capital adequacy require the Corporation to maintain minimum amounts and ratios of Total and Tier 1 capital (primarily common stock and retained earnings, less goodwill) to risk weighted assets, and of Tier 1 capital to average assets. Management believes that as of September 30, 2012, the Corporation meets all capital adequacy requirements to which it is subject.

	Actual Amount	Ratio	For Capital		To Be Well	
			Adequacy Purposes Amount	Ratio	Capitalized Under	Prompt Corrective
					Actions Provisions Amount	Ratio
As of September 30, 2012						
Total Capital (to Risk-Weighted Assets)	\$ 86,657,385	18.24%	\$ 38,001,783	>8.00%	\$ 47,502,229	>10.00%
Tier 1 Capital (to Risk-Weighted Assets)	80,700,944	16.99%	19,000,892	>4.00%	28,501,337	>6.00%
Tier 1 Capital (to Average Assets)	80,700,944	9.55%	33,805,760	>4.00%	42,257,201	>5.00%

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## RESULTS OF OPERATIONS

The following table sets forth for the periods indicated, certain items in the consolidated statements of income of the Corporation and the related changes between those periods:

	For the Three Months		For the Nine Months	
	Ended September 30, 2012	2011	Ended September 30, 2012	2011
Interest Income, including fees	\$ 8,275,350	\$ 9,423,068	\$ 26,177,508	\$ 28,212,191
Interest Expense	1,397,066	1,590,197	4,364,908	5,039,518
<b>Net Interest Income</b>	<b>6,878,284</b>	<b>7,832,871</b>	<b>21,812,600</b>	<b>23,172,673</b>
Provision for Loan Losses	462,684	1,659,873	1,328,461	2,586,707
<b>Net Interest Income after Provision for Loan Losses</b>	<b>6,415,600</b>	<b>6,172,998</b>	<b>20,484,139</b>	<b>20,585,966</b>
Other Income	1,840,565	2,446,812	5,087,320	5,547,673
Other Expense	6,272,876	6,699,927	19,357,144	19,346,247
<b>Income Before Provision For Income Taxes</b>	<b>1,983,289</b>	<b>1,919,883</b>	<b>6,214,315</b>	<b>6,787,392</b>
Provision for Income Taxes	354,247	297,525	1,170,509	1,355,876
<b>Net Income</b>	<b>\$ 1,629,042</b>	<b>\$ 1,622,358</b>	<b>\$ 5,043,806</b>	<b>\$ 5,431,516</b>
Net Income Per share - Basic	\$ 0.34	\$ 0.33	\$ 1.04	\$ 1.12
<b>Net Income Per Share-Diluted</b>	<b>\$ 0.33</b>	<b>\$ 0.33</b>	<b>\$ 1.04</b>	<b>\$ 1.12</b>

See Note 3 to the Corporation's Consolidated Financial Statements for an explanation regarding the Corporation's calculation of Net Income Per Share - basic and - diluted.

Annualized return on average equity ( ROE ) was 7.38% for the three months ended September 30, 2012, and 7.68% for the corresponding period in 2011. This decrease in ROE was caused by an increase in average equity greater than the increase in net income. For the nine months ended September 30, 2012, ROE was 7.62% compared to 8.93% for the nine months ended September 30, 2011. This decrease in ROE was caused by an increase in average equity along with a decrease in net income.

The book value per share increased to \$18.18 at September 30, 2012, compared to \$17.77 at December 31, 2011. The increase in book value per share reflects the increase in other comprehensive income due to the increase in fair value of the Corporation's investment securities and by the amount of earnings in excess of dividends. Average assets for the nine months ended September 30, 2012, were \$839,212,412 compared to \$829,177,021 for the year ended December 31, 2011.



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**NET INTEREST INCOME / NET INTEREST MARGIN**

One component of the Corporation's earnings is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid for deposits and borrowed funds. The net interest margin is net interest income expressed as a percentage of average earning assets.

The annualized net interest margin was 3.74% for the third quarter of 2012 compared to 4.31% for the corresponding period of 2011. For the nine months ended September 30, 2012, annualized net interest margin was 4.00% compared to 4.28% for the nine months ended September 30, 2011. The decrease in net interest margin from 2011 to 2012 is the result of a decrease in yields on earning assets compared to the decrease in rates paid on deposits and borrowed funds, offset partially by an increase in average earning assets, as detailed below. Earning assets averaged \$779,029,468 for the three months ended September 30, 2012. This represents an increase of \$18,232,009, or 2.4%, over average earning assets of \$760,797,459 for the three month period ended September 30, 2011. Earning assets averaged \$770,242,980 for the nine months ended September 30, 2012. This represents an increase of \$17,636,353, or 2.3% over average earning assets of \$752,606,627 for the nine months ended September 30, 2011. The increase in earning assets for the three and nine months ended September 30, 2012, is the result of an increase in investment securities offset partially by a decrease in loans due to the declining loan demand due to current local, national and international economic conditions.

Interest bearing deposits averaged \$508,966,402 for the three months ended September 30, 2012. This represents an increase of \$53,288,447, or 11.7%, from the average of interest bearing deposits of \$455,677,955 for the three-month period ended September 30, 2011. This was due, in large part, to an increase in certificates of deposit and interest-bearing NOW and money market accounts.

Other borrowed funds averaged \$132,036,841 for the three months ended September 30, 2012. This represents a decrease of \$58,652,220, or 30.8%, over the other borrowed funds of \$190,689,061 for the three-month period ended September 30, 2011. This decrease in other borrowed funds was due to a \$49,253,893 decrease in the Commercial Repo Liability, a \$7,923 increase in the Agribusiness Enterprise Loan Liability, a \$3,724,185 increase in Federal Funds Purchased and a decrease in the FHLB advances of \$13,130,435 for the three-month period ended September 30, 2012, when compared to the three-month period ended September 30, 2011.

Interest bearing deposits averaged \$478,826,876 for the nine months ended September 30, 2012. This represents an increase of \$34,349,553, or 7.7%, from the average of interest bearing deposits of \$444,477,323 for the nine-month period ended September 30, 2011.

Other borrowed funds averaged \$159,706,569 for the nine months ended September 30, 2012. This represents a decrease of \$40,894,186, or 20.4%, over the other borrowed funds of \$200,600,755 for the nine-month period ended September 30, 2011. This decrease in other borrowed funds was due to a \$28,616,757 decrease in the Commercial Repo Liability, a \$67,995

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decrease in the Agribusiness Enterprise Loan Liability, a \$1,127,744 increase in Federal Funds Purchased and a decrease in the FHLB advances of \$13,337,178 for the nine-month period ended September 30, 2012, when compared to the nine-month period ended September 30, 2011.

Net interest income was \$6,878,284 for the three-month period ended September 30, 2012, a decrease of \$954,587 from \$7,832,871 for the three-month period ended September 30, 2011, primarily due to changes in rate. The changes in volume in earning assets and in deposits and in borrowed funds are discussed above. As to changes in rate in the three-month period ended September 30, 2012, the yield on earning assets decreased more than the rates paid on deposits and borrowed funds decreased from the same period in 2011. The yield on all interest bearing assets decreased 68 basis points to 4.47% in the third quarter of 2012 from 5.15% for the same period in 2011. At the same time, the rate paid on all interest bearing liabilities for the third quarter of 2012 decreased by 12 basis points to 0.87% from 0.99% in the same period of 2011. As longer term interest bearing assets and liabilities mature and reprice, management believes that the yields on interest bearing assets and rates on interest bearing liabilities will both decrease.

Net interest income was \$21,812,600 for the nine months ended September 30, 2012, a decrease of \$1,360,073 from the \$23,172,673 for the nine-months ended September 30, 2011, primarily due to changes in both rate and volume. The changes in volume in earning assets and in deposits and in borrowed funds are discussed above. As to changes in rate in the nine-month period ended September 30, 2012, the yield on earning assets decreased more than the rates paid on deposits and borrowed funds as compared to the changes in rates and yields in the same period of 2011. The yield on all interest bearing assets decreased 41 basis points to 4.76% in the first nine months of 2012 from 5.17% for the same period in 2011. At the same time, the rate paid on all interest bearing liabilities for the first nine months of 2012 decreased 13 basis points to 0.91% from 1.04% in the same period in 2011. As longer term interest bearing assets and liabilities mature and reprice, management believes that the yields on interest bearing assets and rates on interest bearing liabilities will both decrease.

The following table shows the interest and fees and corresponding yields for loans only.

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2012	2011	2012	2011
Interest and Fees	\$ 5,633,206	\$ 6,306,980	\$ 17,643,633	\$ 19,254,589
Average Loans	378,253,471	406,037,412	385,259,136	412,278,737
Annualized Yield	5.96%	6.21%	6.11%	6.23%

The decrease in interest rates in the nine-month period ended September 30, 2012, reflects the decrease in all loan interest rates for both new and refinanced loans in the period.

**CREDIT LOSS EXPERIENCE**

As a natural corollary to the Corporation's lending activities, some loan losses are to be expected. The risk of loss varies with the type of loan being made and the overall creditworthiness of the

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borrower over the term of the loan. The degree of perceived risk is taken into account in establishing the structure of, and interest rates and security for, specific loans and for various types of loans. The Corporation attempts to minimize its credit risk exposure by use of thorough loan application and approval procedures.

The Corporation maintains a program of systematic review of its existing loans. Loans are graded for their overall quality. Those loans, which the Corporation's management determines require further monitoring and supervision, are segregated and reviewed on a regular basis. Significant problem loans are reviewed on a monthly basis by the Corporation's Board of Directors.

The Corporation charges off that portion of any loan that management has determined to be a loss. A loan is generally considered by management to represent a loss in whole or in part when exposure beyond the collateral value is apparent, servicing of the unsecured portion has been discontinued or collection is not anticipated based on the borrower's financial condition. The general economic conditions in the borrower's industry influence this determination. The principal amount of any loan that is declared a loss is charged against the Corporation's allowance for loan losses.

The Corporation's allowance for loan losses is designed to provide for loan losses that can be reasonably anticipated. The allowance for loan losses is established through charges to operating expenses in the form of provisions for loan losses. Actual loan losses or recoveries are charged or credited to the allowance for loan losses. Management of the Corporation determines the amount of the allowance. Among the factors considered in determining the allowance for loan losses are the current financial condition of the Corporation's borrowers and the value of security, if any, for their loans. Estimates of future economic conditions and their impact on various industries and individual borrowers are also taken into consideration, as are the Corporation's historical loan loss experience and reports of banking regulatory authorities. As these estimates, factors and evaluations are primarily judgmental, no assurance can be given as to whether the Corporation will sustain loan losses in excess or below its allowance or that subsequent evaluation of the loan portfolio may not require material increases or decreases in such allowance.

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The following table summarizes the Corporation's allowance for loan losses for the dates indicated:

	Quarter Ended September 30, 2012	Year Ended December 31, 2011	Amount of Increase (Decrease)	Percent of Increase (Decrease)
<b>BALANCES:</b>				
Gross Loans	\$ 378,442,225	\$ 389,466,242	\$ (11,024,017)	-2.83%
Allowance for Loan Losses	7,449,432	6,681,412	768,020	11.49%
Nonaccrual Loans	14,500,317	11,299,060	3,201,257	28.33%
<b>Ratios:</b>				
Allowance for loan losses to gross loans	1.97%	1.72%		
Net loans charged off to allowance for loan losses	7.52%	40.31%		

The provision for loan losses for the three months ended September 30, 2012, was \$462,684, a decrease of \$1,197,189 from the \$1,659,873 provision for the same period in 2011. The provision for loan losses was \$1,328,461 for the nine month period ended September 30, 2012, compared to a provision of \$2,586,707 for the nine months ended September 30, 2011. The decrease in our loan loss provisions for the three and nine month periods is a result of a decrease in loan losses recorded for the respective periods and management's assessment of inherent loss in the loan portfolio, including the impact caused by current local, national and global economic conditions. The Corporation's model used to calculate the provision is based on the percentage of historical charge-offs applied to the current loan balances by loan segment and specific reserves applied to certain impaired loans. Nonaccrual loans decreased during this period due to payments received in excess of the amount of new loans being added to the list.

For the three months ended September 30, 2012, net loan losses charged to the allowance for loan losses totaled \$223,969, a decrease of \$391,088 from the \$615,057 charged off in the same period in 2011. For the nine months ended September 30, 2012, net loan losses charged to the allowance for loan losses totaled \$560,441, a decrease of \$1,000,918 from the \$1,561,359 charged off in the same period in 2011. This decrease was due to an overall decrease in the number of charge offs in 2012 when compared to the same period in 2011 and not the result of any one loan segment.

Management reviews with the Board of Directors the adequacy of the allowance for loan losses on a quarterly basis. The loan loss provision is adjusted when specific items reflect a need for such an adjustment. Management believes that there were no material loan losses during the first nine months of 2012 that have not been charged off. Management also believes that the Corporation's allowance will be adequate to absorb probable losses inherent in the Corporation's loan portfolio. However, in light of overall economic conditions in the Corporation's geographic area, the nation and internationally, as a whole, it is possible that additional provisions for loan loss may be required.

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Other income includes service charges on deposit accounts, wire transfer fees, safe deposit box rentals and other revenue not derived from interest on earning assets. Other income for the three months ended September 30, 2012, was \$1,840,565, a decrease of \$606,247, or 24.8%, from the same period in 2011. Service charges on deposit accounts decreased by \$33,329, or 3.3%, to \$966,149 in the three months ended September 30, 2012, compared to \$999,478 for the same period in 2011. Other service charges and fees increased by \$35,272, or 7.4%, in the three months ended September 30, 2012, compared to the same period in 2011. The difference in fee income was the result of fluctuations in volume and not a direct result of fee changes.

Other income for the nine months ended September 30, 2012, was \$5,087,320, a decrease of \$460,353, or 8.3%, from the same period in 2011. Service charges on deposit accounts decreased by \$18,142, or 0.7%, to \$2,711,719 in the nine months ended September 30, 2012, compared to \$2,729,861 for the same period in 2011. Other service charges and fees increased by \$35,272, or 2.7%, in the nine months ended September 30, 2012, compared to the same period in 2011. The difference in fee income was the result of fluctuations in volume and not a direct result of fee changes.

The following is a detail of the other major income classifications that are included in Other Income on the income statement:

	Three months		Nine months	
	ended September 30, 2012	2011	ended September 30, 2012	2011
Other Income				
BOLI Insurance	\$ 120,000	\$ 135,544	\$ 360,000	\$ 372,853
Mortgage Loan Origination Income	124,302	89,232	341,314	257,725
Income from Security Sales, net	5,972	636,542	43,725	642,331
Other Income	114,699	111,845	255,050	241,599
<b>Total Other Income</b>	<b>\$ 364,973</b>	<b>\$ 973,163</b>	<b>\$ 1,000,089</b>	<b>\$ 1,514,508</b>

**OTHER EXPENSES**

Other expenses include salaries and employee benefits, occupancy and equipment, and other operating expenses. Aggregate non-interest expenses for the three-month period ended September 30, 2012 and 2011 were \$6,272,876 and \$6,699,927, respectively, a decrease of \$427,051, or 6.4%, from 2011 to 2012. Salaries and benefits decreased to \$3,414,811 for the three months ended September 30, 2012, from \$3,518,464 for the same period in 2011. This represents a decrease of \$103,653, or 2.9%. This decrease was the result of decreases in the cost of employee benefits paid by the Corporation and a reduction in the number of employees. Occupancy expense increased by \$66,804, or 6.2%, to \$1,147,917 for the three months ended September 30, 2012, when compared to the same period of 2011. This increase is due in part to an increase in office and equipment rental and service costs. Other operating expenses decreased by \$390,202 from 2011 to 2012. A detail of the major expense classifications is set forth below.

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Total non-interest expenses for the nine-month period ended September 30, 2012 and 2011 were \$19,357,144 and \$19,346,247, respectively, an increase of \$10,897, or 0.1%, from 2011 to 2012. Salaries and benefits decreased to \$10,448,471 for the nine months ended September 30, 2012, from \$10,562,176 for the same period in 2011. This represents a decrease of \$113,705, or 1.1%. This decrease was the result of a reduction in the number of employees. Occupancy expense increased \$88,480, or 2.8%, to \$3,277,082 in the nine months ended September 30, 2012 when compared to the same period in 2011. Other operating expenses increased by \$36,122 from 2011 to 2012. A detail of the major expense classifications is set forth below.

The following is a detail of the major expense classifications that make up the other operating expense line item in the income statement:

	Three months		Nine months	
	ended September 30,		ended September 30,	
	2012	2011	2012	2011
Other Operating Expense				
Intangible Amortization	\$	\$ 46,173	\$ 76,955	\$ 138,518
Advertising	147,144	212,313	480,798	563,975
Office Supplies	114,656	100,325	323,364	403,575
Legal and Audit Fees	120,751	105,956	347,530	343,116
Telephone expense	110,353	103,245	322,019	317,397
Postage and Freight	98,489	82,618	328,522	275,492
Loan Collection Expense	81,878	247,794	311,376	289,845
Other Losses	4,104	10,126	33,502	21,628
FDIC and State Assessment	320,416	310,458	948,832	843,328
Debit Card/ATM expense	210,180	166,747	607,764	552,108
Travel and Convention	35,968	57,870	141,179	196,649
Other expenses	466,209	656,725	1,709,750	1,649,838
<b>Total Other Expense</b>	<b>\$ 1,710,148</b>	<b>\$ 2,100,350</b>	<b>\$ 5,631,591</b>	<b>\$ 5,595,469</b>

The Corporation's efficiency ratio for the three months ended September 30, 2012, was 71.53% compared to the 63.22% for the same period in 2011. For the nine months ended September 30, 2012 and 2011, the Corporation's efficiency ratio was 70.16% and 65.20%, respectively. The efficiency ratio is the ratio of non-interest expenses divided by the sum of net interest income (on a fully tax equivalent basis) and non-interest income.

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## BALANCE SHEET ANALYSIS

	September 30, 2012	December 31, 2011	Amount of Increase (Decrease)	Percent of Increase (Decrease)
Cash and Due From Banks	\$ 20,130,091	\$ 35,407,715	\$ (15,277,624)	-43.15%
Interest Bearing deposits with Other Banks	2,151,946	3,990,521	(1,838,575)	-46.07%
Investment Securities	398,200,446	374,507,805	23,692,641	6.33%
Loans, net	370,750,748	382,580,529	(11,829,781)	-3.09%
Total Assets	847,897,471	853,945,454	(6,047,983)	-0.71%
Total Deposits	617,022,279	572,338,135	44,684,144	7.81%
Total Stockholders Equity	88,400,812	86,079,217	2,321,595	2.70%

## CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of cash, balances at correspondent banks, interest bearing deposits with other banks and items in process of collection. The balance at September 30, 2012, was \$22,282,037, a decrease of \$17,116,199 from the balance of \$39,398,236 at December 31, 2011, due to an decrease in the balances at correspondent banks due to an increase in the amount of the month ending cash letter and by a decrease in the balances of interest bearing deposits with other banks.

## PREMISES AND EQUIPMENT

During the period ended September 30, 2012, premises and equipment decreased by \$787,812, or 3.9%, to \$19,490,631 when compared to \$20,278,443 at December 31, 2011. The decrease was due to the amount of depreciation exceeding the addition of property and equipment in the normal course of business.

## INVESTMENT SECURITIES

The investment securities portfolio consists of United States agency debentures, mortgage-backed securities, obligations of states, counties and municipal governments and FHLB stock and FNBB stock. Investments at September 30, 2012, increased \$23,692,641, or 6.3%, to \$398,200,446 from \$374,507,805 at December 31, 2011. This increase is due to the investment of excess liquidity not needed to fund loans during the reporting period.

## LOANS

The loan balance decreased by \$11,829,781 during the nine months ended September 30, 2012, to \$370,750,748 from \$382,580,529 at December 31, 2011. Loan demand, especially in the commercial and industrial loan and consumer categories, was weak during the first nine months of 2012. No material changes were made to the loan products offered by the Corporation during this period.

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## DEPOSITS

The following table shows the balance and percentage change in the various deposits:

	September 30, 2012	December 31, 2011	Amount of Increase (Decrease)	Percent of Increase (Decrease)
Noninterest-Bearing Deposits	\$ 107,337,450	\$ 116,894,676	\$ (9,557,226)	-8.18%
Interest-Bearing Deposits	211,875,266	172,585,498	39,289,768	22.77%
Savings Deposits	46,051,865	41,876,977	4,174,888	9.97%
Certificates of Deposit	251,757,698	240,980,984	10,776,714	4.47%
<b>Total Deposits</b>	<b>\$ 617,022,279</b>	<b>\$ 572,338,135</b>	<b>\$ 44,684,144</b>	<b>7.81%</b>

Interest-bearing deposits, certificates of deposit and savings increased while noninterest-bearing deposits decreased during the nine months ended September 30, 2012. Management continually monitors the interest rates on loan and deposit products to ensure that the Corporation is in line with the rates dictated by the market and our asset and liability management. These rate adjustments impact deposit balances.

## OFF-BALANCE SHEET ARRANGEMENTS

Refer to Note 2 to the consolidated financial statements included in this report for a discussion of the nature and extent of the Corporation's off-balance sheet arrangements, which consist of commitments to fund loans and letters of credit.

## CONTRACTUAL OBLIGATIONS

There have been no material changes outside of the ordinary course of the Corporation's business to the contractual obligations set forth in Note 12 to the Corporation's financial statements contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The following discussion outlines specific risks that could affect the Corporation's ability to compete, change the Corporation's risk profile or eventually impact the Corporation's financial results. The risks the Corporation faces generally are similar to those experienced, to varying degrees, by all financial services companies.

The Corporation's strategies and its management's ability to react to changing competitive and economic environments have historically enabled the Corporation to compete effectively and manage risks to acceptable levels. The Corporation has outlined potential risk factors below that it presently believe could be important; however, other risks may prove to be important in the future. New risks may emerge at any time and the Corporation cannot predict with certainty all



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potential developments which could affect the Corporation's financial performance. The following discussion highlights potential risks, which could intensify over time or shift dynamically in a way that might change the Corporation's risk profile.

### Competition Risks

The market in which the Corporation competes is saturated with community banks seeking to provide a service oriented banking experience to individuals and businesses compared with what the Corporation believes is the more rigid and less friendly environment found in large banks. This requires the Corporation to offer most, if not all, of the products and conveniences that are offered by the larger banks with a service differentiation. In doing so, it is imperative that the Corporation identify the lines of business that the Corporation can excel in, prudently utilize the Corporation's available capital to acquire the people and platforms required thereof and execute on the strategy.

### Credit Risks

Like all lenders, the Corporation faces the risk that the Corporation's customers may not repay their loans and that the realizable value of collateral may be insufficient to avoid a loss of principal. In the Corporation's business, some level of credit loss is unavoidable and overall levels of credit loss can vary over time. Our ability to manage credit risks depends primarily upon the Corporation's ability to assess the creditworthiness of customers and the value of collateral, including real estate. The Corporation controls credit risk by diversifying the Corporation's loan portfolio and managing its composition, and by recording and managing an allowance for expected loan losses in accordance with applicable accounting rules. At the end of September 30, 2012, the Corporation had \$7.449 million of available reserves to cover such losses. The models and approaches the Corporation uses to originate and manage loans are regularly updated to take into account changes in the competitive environment, in real estate prices and other collateral values, and in the economy, among other things based on the Corporation's experience originating loans and servicing loan portfolios.

### Financing, Funding and Liquidity Risks

One of the most important aspects of management's efforts to sustain long-term profitability for the Corporation is the management of interest rate risk. Management's goal is to maximize net interest income within acceptable levels of interest-rate risk and liquidity.

The Corporation's assets and liabilities are principally financial in nature and the resulting earnings thereon are subject to significant variability due to the timing and extent to which the Corporation can reprice the yields on interest-earning assets and the costs of interest bearing liabilities as a result of changes in market interest rates. Interest rates in the financial markets affect the Corporation's decisions on pricing its assets and liabilities which impacts net interest income, an important cash flow stream for the Corporation. As a result, a substantial part of the Corporation's risk-management activities are devoted to managing interest-rate risk. Currently, the Corporation does not have any significant risks related to foreign exchange, commodities or equity risk exposures.

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### **Interest Rate and Yield Curve Risks**

A significant portion of the Corporation's business involves borrowing and lending money. Accordingly, changes in interest rates directly impact the Corporation's revenues and expenses, and potentially could compress the Corporation's net interest margin. The Corporation actively manages its balance sheet to control the risks of a reduction in net interest margin brought about by ordinary fluctuations in rates.

Like all financial services companies, the Corporation faces the risks of abnormalities in the yield curve. The yield curve simply shows the interest rates applicable to short and long term debt. The curve is steep when short-term rates are much lower than long-term rates: it is flat when short-term rates are equal, or nearly equal, to long-term rates: and it is inverted when short-term rates exceed long-term rates. Historically, the yield curve is positively sloped. A flat or inverted yield curve tends to decrease net interest margin, as funding costs increase relative to the yield on assets. Currently, the yield curve is positively sloped.

### **Regulatory and Legal Risks**

The Corporation operates in a heavily regulated industry and therefore is subject to many banking, deposit, and consumer lending regulations in addition to the rules applicable to all companies publicly traded in the U.S. securities markets. Failure to comply with applicable regulations could result in financial, structural, and operational penalties. In addition, efforts to comply with applicable regulations may increase the Corporation's costs and, or limit the Corporation's ability to pursue certain business opportunities. Federal and state regulations significantly limit the types of activities in which the Corporation, as a financial institution, may engage. In addition, the Corporation is subject to a wide array of other regulations that govern other aspects of how the Corporation conducts business, such as in the areas of employment and intellectual property. Federal and state legislative and regulatory authorities occasionally consider changing these regulations or adopting new ones. Such actions could limit the amount of interest or fees the Corporation can charge, could restrict the Corporation's ability to collect loans or realize on collateral or could materially affect us in other ways. Additional federal and state consumer protection regulations also could expand the privacy protections afforded to customers of financial institutions, restricting the Corporation's ability to share or receive customer information and increasing the Corporation's costs. In addition, changes in accounting rules can significantly affect how the Corporation records and reports assets, liabilities, revenues, expenses and earnings.

The Corporation also faces litigation risks from customers (individually or in class actions) and from federal or state regulators. Litigation is an unavoidable part of doing business, and the Corporation manages those risks through internal controls, personnel training, insurance, litigation management, the Corporation's compliance and ethics processes and other means. However, the commencement, outcome and magnitude of litigation cannot be predicted or controlled with certainty.

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### Accounting Estimate Risks

The preparation of the Corporation's consolidated financial statements in conformity with United States generally accepted accounting principles requires management to make significant estimates that affect the financial statements. The Corporation's most critical estimate is the level of the allowance for credit losses. However, other estimates occasionally become highly significant, especially in volatile situations such as litigation and other loss contingency matters. Estimates are made at specific points in time; as actual events unfold, estimates are adjusted accordingly. Due to the inherent nature of these estimates, it is possible that, at some time in the future, the Corporation may significantly increase the allowance for credit losses or sustain credit losses that are significantly higher than the provided allowance, or the Corporation may make some other adjustment that will differ materially from the estimates that the Corporation makes today.

### Expense Control

Expenses and other costs directly affect the Corporation's earnings. The Corporation's ability to successfully manage expenses is important to its long-term profitability. Many factors can influence the amount of the Corporation's expenses, as well as how quickly they grow. As the Corporation's businesses change or expand, additional expenses can arise from asset purchases, structural reorganization evolving business strategies, and changing regulations, among other things. The Corporation manages expense growth and risk through a variety of means, including actual versus budget management, imposition of expense authorization, and procurement coordination and processes.

### ITEM 4. CONTROLS AND PROCEDURES.

The management of the Corporation, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures in ensuring that the information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, including ensuring that such information is accumulated and communicated to the Corporation's management as appropriate to allow timely decision regarding required disclosure. Based on such evaluation, our principal executive officer and principal financial officer have concluded that such disclosure controls and procedures were effective as of September 30, 2012 (the end of the period covered by this Quarterly Report on Form 10-Q).

There were no changes to the Corporation's internal control over financial reporting that occurred in the three months ended September 30, 2012, that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS.

The Corporation is supplementing the risk factors that appear in Part I, Item 1A., Risk Factors, of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011, to include the following.

**Changes in interest rates could make it difficult to maintain our current interest income spread and could result in reduced earnings.**

Our earnings are largely derived from net interest income, which is interest income and fees earned on loans and investments, less interest paid on deposits and other borrowings. Interest rates are highly sensitive to many factors that are beyond the control of our management, such as general economic conditions and the policies of various governmental and regulatory authorities. An unanticipated rapid decrease or increase in interest rates could have an adverse effect on the spreads between the interest rates earned on assets and the rates of interest paid on liabilities, and therefore on the level of net interest income. Further, substantially higher interest rates generally reduce loan demand and may result in slower loan growth than previously experienced. Due to concerns regarding the federal debt ceiling, one credit rating agency has downgraded the credit rating of the federal government, and others may as well, which could result in increased interest rates generally. For the reasons set forth above, an increase in interest rates generally as a result of such a credit rating downgrade could adversely affect our net interest income levels, thereby resulting in reduced earnings, and reduce loan demand.

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ITEM 6. EXHIBITS.

Exhibits

- 31(a) Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 31(b) Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 32(a) Certification of the Chief Executive Officer pursuant to 18 U.S.C. § 1350.
- 32(b) Certification of the Chief Financial Officer pursuant to 18 U.S.C. § 1350.
- 101 The following financial information from Citizens Holding Company's Quarterly Report on Form 10-Q for the period ended September 30, 2012, filed with the SEC on November 9, 2012, formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Statements of Condition as of September 30, 2012 (Unaudited) and December 31, 2011; (ii) the Consolidated Statements of Income for the three and nine months ended September 30, 2012 (Unaudited) and 2011 (Unaudited); (iii) the Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 (Unaudited) and 2011 (Unaudited); (iv) the Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 (Unaudited) and 2011 (Unaudited); and (v) Notes to Consolidated Financial Statements, tagged as blocks of text (Unaudited).\*

\* Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be deemed part of a registration statement, prospectus or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filings.

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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 HOLDING COMPANY

BY: /s/ Greg L. McKee  
Greg L. McKee  
President and Chief Executive Officer  
(Principal Executive Officer)

BY: /s/ Robert T. Smith  
Robert T. Smith  
Treasurer and Chief Financial Officer  
(Principal Financial Officer and Chief Accounting Officer)

DATE: November 7, 2012

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**EXHIBIT INDEX**

Exhibit Number	Description of Exhibit
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